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# HUD'S GOVERNMENT-INSURED MORTGAGES: THE PROBLEM OF PROPERTY "FLIPPING"

## HEARINGS

BEFORE THE

PERMANENT
SUBCOMMITTEE ON INVESTIGATIONS

OF THE

COMMITTEE ON
GOVERNMENTAL AFFAIRS
UNITED STATES SENATE

ONE HUNDRED SIXTH CONGRESS

SECOND SESSION

JUNE 29 AND 30, 2000

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# CONTENTS

Page

EXHIBIT LIST

# HUD'S GOVERNMENT-INSURED MORTGAGES: THE PROBLEM OF PROPERTY "FLIPPING"

**THURSDAY, JUNE 29, 2000**

U.S. SENATE,
PERMANENT SUBCOMMITTEE ON INVESTIGATIONS,
OF THE COMMITTEE ON GOVERNMENTAL AFFAIRS,
*Washington, DC.*

The Subcommittee met, pursuant to notice, at 9:30 a.m., in room SD–342, Dirksen Senate Office Building, Hon. Susan M. Collins, Chairman of the Subcommittee, presiding.

Present: Senators Collins and Durbin.

Staff Present: K. Lee Blalack II, Chief Counsel and Staff Director; Mary D. Robertson, Chief Clerk; Rena Johnson, Deputy Chief Counsel; Karina Lynch, Counsel; Brian C. Jones, Investigator; Claire Barnard, Detailee/HHS; Jim Pittrizzi, Detailee/GAO; Raymond Kessenich, Detailee/NCIS; Elizabeth Hays, Staff Assistant; Bob Slama, Detailee/Secret Service; Bob Groves, Detailee/HUD OIG; Courtney Hays, Intern; Joe Kosnow, Intern; Adam Thomas, Intern; Felicia Knight (Senator Collins); Steve Abbott (Senator Collins); Tracy Shollenberger (Senator Specter); James Twaddell (Senator Specter); Marianne Upton (Senator Durbin); Glen Sauer (Senator Akaka); Jessica Porras (Senator Durbin); and Jonathan Mervis (Senator Durbin).

## OPENING STATEMENT OF SENATOR COLLINS

Senator COLLINS. The Subcommittee will come to order.

Good morning. During the next 2 days, the Permanent Subcommittee on Investigations will examine a type of mortgage fraud commonly known as "flipping." Flipping is a complex fraud that involves the purchase and then resale of property at greatly inflated prices. This fraudulent scheme increasingly plagues our Nation's cities and victimizes first-time homebuyers. Indeed, the evidence gathered by the Subcommittee during its 9-month investigation suggests, as Senator Mikulski has previously noted, that flipping is spreading like a virus that, if left unchecked, could reach epidemic proportions.

Property flipping generally involves con artists who purchase dilapidated homes at bargain prices, usually in economically distressed parts of the city. These properties are then quickly resold at a tremendous markup—often 100 percent or more. It is not uncommon for "flippers" to buy and sell the same property within a few months, or even days.

In flipping schemes, the sellers frequently make cosmetic repairs to the property such as carpeting over damaged wood floors or painting over termite damage so that it is not visible. They then sell the home to an unsuspecting purchaser, usually targeting low-income, first-time homebuyers. The targeted buyers are normally unsophisticated financially and have little experience with financial transactions, much less the real estate market. Through high-pressure tactics, the sellers persuade these buyers to rely on them completely. They arrange for the buyers to obtain a mortgage loan, often by doctoring the buyers' financial and credit information. To support the grossly inflated sales price, the sellers often obtain dubious appraisals from unscrupulous appraisers who are part of the scam.

After the buyers move into their new homes, they soon discover that the "total rehab" they were promised is little more than a crumbling relic. Their dream of homeownership quickly turns into a nightmare. Our investigation found that many buyers are left with homes that are virtually uninhabitable. Others are forced to make costly repairs that they can scarcely afford. In addition, because the homes are sold at exorbitant markups, the buyers are often saddled with mortgage payments that exceed their ability to pay. The end result for these unfortunate homeowners is often default and eventually the loss of their homes through foreclosure. While the property flippers walk away from the sale with huge profits, the homebuyers are often left with no home, broken promises, and a tarnished credit rating.

During our extensive investigation, the Subcommittee staff interviewed scores of low-income homebuyers who had been duped by property flippers. Let me tell you the story of one of them. The tragic story of Gladys Hall, a 54-year-old Chicago resident, illustrates how these flipping scams work and testifies to the emotional and financial toll that results from this fraud.

In early 1996, Ms. Hall contacted a local real estate agency in response to a flyer that had been circulated in her neighborhood, urging her to "rent to buy." After speaking with a sales agent, she was persuaded to purchase a home owned by the real estate agency that was located in the South Austin area of Chicago.

At that time, Ms. Hall was unemployed, and her only source of income was Supplemental Security Income, SSI. Even though Ms. Hall obviously had very little means, the seller arranged for her to obtain an FHA-backed mortgage to purchase the house for $122,000. Property records indicate that the real estate agency selling her the house had purchased the property 22 months earlier for only $11,000. That is a markup of over 1,000 percent.

At the time of the sale, the real estate agent assured Ms. Hall that his agency would thoroughly rehabilitate the house. Soon after she moved into her new home, however, Ms. Hall discovered that the structure was leaning noticeably, the roof leaked, and the plumbing didn't work. In addition, even though the sales agent assured Ms. Hall that her monthly mortgage payment would be about $500, it soon skyrocketed to $1,000 a month. It turned out to be an adjustable rate mortgage, something that Ms. Hall told the Subcommittee staff she did not understand at the time of the sale. She did not realize that if interest rates increased, her mortgage payment could also increase dramatically.

Not surprisingly, Ms. Hall soon fell behind in her mortgage payments. In 1998, the lender foreclosed, obtained payment on the insurance from FHA, and returned the property to the Department of Housing and Urban Development. Ms. Hall is now living in a public housing project in Chicago.

When HUD sold Ms. Hall's home in April of this year, it received only $24,990. The insurance fund run by HUD picked up the difference, incurring a loss of over $90,000. The Subcommittee staff sought to question the principals of the real estate agency that sold this property to Ms. Hall; however, those individuals asserted their Fifth Amendment rights and refused to answer any questions.[1]

Unfortunately, Ms. Hall's experience is far from unique. We will hear testimony today from three witnesses who were also victimized by flipping schemes very similar to the one perpetrated on Ms. Hall. Moreover, HUD's Office of Inspector General reported in its report to Congress dated March 31 of this year that it had uncovered "massive fraud schemes surrounding the origination of single-family homes insured by HUD." Six months ago, a Federal grand jury in Los Angeles charged 39 persons with fraudulently obtaining more than $110 million worth of FHA-insured loans through the execution of multiple flipping schemes that typically inflated the value of the properties as much as $150,000.

And, just 2 weeks ago, Federal prosecutors in Florida charged 10 people with fraudulently securing more than 200 FHA-insured loans valued in excess of $17 million. One of the defendants has apparently told authorities that they targeted first-time homebuyers in predominantly working-class, minority neighborhoods. This fraud ring followed a familiar formula: Buy properties in distressed conditions at very low prices, perform minor cosmetic improvements, and then resell the homes at drastically inflated prices to unsophisticated buyers.

I find it very troubling that so many citizens in our Nation's cities have been victimized by the predatory practices of unscrupulous real estate agencies, appraisers, and lenders. But what I find most appalling is that the Federal Government has essentially subsidized much of this fraud. HUD, through FHA, insures many of the mortgages that finance these fraudulent transactions. A series of audits and reports over several years warned HUD repeatedly of the vulnerability of its mortgage programs to fraud. But the Department has been slow to act to curtail this fraud.

When a lender forecloses on Gladys Hall or any other flipping victim, it is fully compensated for underwriting the bad loan because FHA pays the insurance claim. Therefore, these flipping schemes often result not only in financial ruin and emotional distress for the buyers and their families, but they also undermine the integrity of the FHA insurance fund by passing on the tab for this fraud to the Federal Government.

The unfortunate irony, of course, is that the victims of property flipping are often the very people whom HUD is intended to help attain the American dream of homeownership. They depend on HUD to protect them from the predatory sales and lending practices that the Subcommittee's investigation revealed. After all,

[1] See Exhibit No. 1 which appears in the Appendix on page 115.

without HUD's help, they would be unable to obtain the conventional mortgages to buy their homes. Their whole access to the housing market depends on obtaining the FHA loan guarantees. Surely, HUD has a duty to protect these unsophisticated homebuyers who are the targets of these fraudulent sales and lending practices as well as to safeguard the integrity of the insurance fund.

The purpose of these hearings is to get to the bottom of this disturbing trend in mortgage fraud. In addition to examining the flipping schemes and the havoc that they wreak on families and neighborhoods, we will consider whether HUD could do more or could have done more to prevent the recent growth in mortgage fraud that has beset the single-family loan program. We will also seek to determine what we can do now working with HUD to put a stop to these predatory practices which threaten the stability of many urban neighborhoods and rob the insurance fund.

I look forward to hearing all of our testimony today, and I think we are especially fortunate to have as our lead-off witness for these hearings my distinguished colleague from Maryland, Senator Barbara Mikulski. Over the past several months, I have followed her efforts very closely, as she has been a leader in remedying the exploding problem of mortgage fraud in the city of Baltimore. She has worked very diligently to expose flipping, and she has been a leader in Congress on this troubling issue. She has been responsible for prompting the Department of Housing and Urban Development to take some action in this area, and I am delighted to have her here today.

Senator Mikulski, you may proceed.

## TESTIMONY OF HON. BARBARA A. MIKULSKI,[1] A U.S. SENATOR FROM THE STATE OF MARYLAND

Senator MIKULSKI. Well, thank you very much, Senator Collins. First of all, I want to thank you for holding this series of hearings to really get in very deeply on the issues of predatory lending. Your own reputation for standing sentry on the issues of fraud is well known. I think senior citizens and their families all over America are grateful for the leadership that you undertook in the telemarketing and other fraud scams against seniors. Remember the "Buy a magazine today, lose your house tomorrow" kind of thing? And all over the State of Maryland I talk about Senator Sue from Maine, who really stopped these scams directed against seniors.

I so welcome the fact that you have now turned your very able and your staff's attention to the issue of flipping. Flipping is a word that has no meaning to it until we really name it, and it is called predatory, predatory lending, and that is what this is all about, where through predatory practices, preying on the poor, that they bought homes at very low cost in very distressed neighborhoods, turned them around at exorbitant profits, had FHA to subsidize their unscrupulous and often illegal behavior, gouging the poor, ripping off the taxpayer, and when the poor can't make their obligations, through no fault of their own, the houses are then foreclosed, and then we have got to dispose of them. And in many of

[1] The prepared statement of Senator Mikulski appears in the Appendix on page 71.

our neighborhoods, the term "a HUD house" is really a despicable term because it is even bringing the neighborhood further down.

So we want to congratulate you on this because there are really two types of flipping: The flipping of real estate, which you have discussed here today; then there is also the flipping of the mortgage, where they take the mortgage and keep flipping it over and over again, adding fees where the transactors sit back and enjoy the largesse, but the working poor, the ones out there who work in day-care centers, often in hospitals as aides and orderlies, or in geriatric services, who end up now at the end of the day with a bad back, varicose veins, and often facing bankruptcy because of these unscrupulous practices. So we thank you for your leadership.

I got into this because of hearing about the stories in our own neighborhood, stories about unsuspecting people trying to buy a home, first-time homeowners often moving from welfare to work, learning that the houses they bought were worth less than half of what they paid, stories of the gouging of the poor by unscrupulous real estate investors, appraisers, title searchers, and even predatory lenders.

In February, I went to a meeting at St. Michael's Church in East Baltimore, where I heard about the problem firsthand. Your own staff was there, and we welcomed their attendance and participation that day.

We learned about crooked appraisers conspiring with crooked lenders to target these unsuspecting first-time homebuyers. By providing misleading and often false information, predatory lenders, brokers, and home improvement contractors were manipulating borrowers into loans that could only result in defaults. The loans were rife with high fees, high points, hidden balloon payments, and the flippers were buying up houses, making quick cosmetic fixes to them so they could be sold at inflated prices.

People were being robbed of their savings, and what should have been the American dream turned into the American nightmare.

I was shocked and outraged, as I know you have been, because of what was happening to the poor, to the taxpayer, and to the neighborhoods.

As the ranking member of the VA/HUD Subcommittee, I turned to another colleague, our mutual friend, Senator Bond, the chairman of that subcommittee, to see if I could hold a field hearing in Baltimore. I cannot thank Senator Bond enough for his bipartisan cooperation through the VA/HUD Subcommittee to at least begin some of this activity. Senator Bond agreed to have this hearing in Baltimore, and we moved on it.

We heard from victims. You are going to hear from them today. I will just say this: There was one lady who worked so hard. She bought a home. She thought for $500 a month she was going to pay this house off in 15 years. Well, guess what? She had a balloon payment of $57,000 in the final year. We heard stories and stories like that. You will hear from them.

Our witnesses had a lot of courage, and I want to thank them for coming forward to tell their stories. But as you said, it is just not going on in Baltimore. It is a cancer destroying our neighborhoods.

The National Consumer Law Center estimates that there are over 600,000 Americans who may lose their homes because they were duped into bad loans. And, Senator Collins, I was afraid that this was going to be another S&L thing. What do I mean by that? Every time they go into default, FHA has to foreclose. The taxpayer loses while the homeowner loses. And as they go into default, we could be losing as much as $20,000, $30,000, or $40,000 on a house, and the taxpayer is holding the liability. We were being ripped off in two ways: The poor and the taxpayer.

Well, what we found in Baltimore was horrifying. Two thousand properties in Baltimore were bought and resold within 120 days. Two thousand properties, moving stressed neighborhoods to siege, at 100 percent profit.

I don't know if that is a vote or I get so excited my beeper goes off, like an EKG here. [Laughter.]

Senator MIKULSKI. Let me just put this here.

Unfortunately, FHA has been an accomplice to the flippers and the predatory lenders due to the large inventory of FHA-owned homes that were ripe for flippers. The stock of FHA housing had deteriorated, and houses were available for depressed prices. See, some of the places were doubly flipped. An FHA house goes into foreclosure, but another sham or dummy corporation buys the foreclosed house and starts the same scam. The scum start the same scam all over again.

Well, you and I want to stop the poor from being gouged, the taxpayer from being ripped off, and our neighborhoods from being destroyed.

After the Baltimore hearing, I had what was called, I think in diplomacy terms, a frank and candid conversation with Secretary Cuomo and said you are either going to have to get into this yourself or you are going to face Senators Bond, Mikulski, Collins, and so on—and, of course, Senator Sarbanes. And I asked him to establish two task forces that I hope provide guidance to the Subcommittee. One was a national one on mortgage lending and so on, and it was involved with the Department of Treasury. I bring that to your attention. The other was the Baltimore task force because we were the worst in the Nation. And thanks to the openness of Mayor O'Malley, our new mayor, we said we are ready for Baltimore to be the laboratory, examine us. And I tell you, Senator Collins, we found under every rock was another rock, and under that rock was worms.

Those predatory lenders were actually meeting in cafes in Baltimore, swapping notes and tips and techniques on how to really gouge the poor and the taxpayer. They actually met to do this.

Well, our able U.S. Attorney got in on this, postal inspectors, and the FBI. These will be part of the kind of things that the Subcommittee can draw upon.

But I will say this: Once Cuomo got into it, things have really begun to develop. Out of the two task forces, they have the recommendations on a prevention plan:

One, early detection of problem loans and early detection of problem lenders. This means a lot of consumer information so that people like the unsuspecting buyers don't get into it;

Second, using technology for credit watches, and provides assistance to the people who have now been victimized;

And then, third, identifying and prosecuting predatory lenders and those in that chain.

And I think if they know that we are coming, they are going to go. We already have anecdotal evidence that the aggressive activity in Baltimore has reduced flipping by about 80 percent, and it is because they know we are coming after them, and they could lose their license, they could go to jail, and maybe they have to lose their home.

So this is the kind of Federal commitment that we want. Senator Sarbanes and I introduced legislation yesterday called "Credit Watch." We invite it to your attention because, again, the predatory crowd was going to use the law to evade the law, saying we had no authority to come after them. So we are ready to get involved with that. Again, as a result of your hearings, we hope that you have the kind of recommendations we could work on on a bipartisan basis.

I bring to your attention the national task force. They have 50 recommendations to stop predatory lending. Let them tell you what they are. I just want you to be aware of them. But we do have a whole series of things that could deal with it: Real estate settlement procedures, also zeroing in on harmful sales practices, and also a way to restrict abusive conditions of high-cost loans.

We are also inviting Fannie Mae, Freddie Mac, and Federal Home to really get in for a major consumer education program for the poor.

We are also recommending the Community Reinvestment Act encourage lenders to move people from sub-prime markets to the conventional. It is the sub-prime area where it is also going on.

I really applaud—Cuomo really got into this, and I want to bring that to your attention. And through this National Predatory Lending Task Force, they do have a blueprint.

Now, this is the Baltimore Task Force Report.[1] I am going to give this to you and to the Subcommittee. It is replete with pictures and so on about how this was actually done.

I believe you have many other witnesses and we have a vote. I would like you to hear from the people who have come from all over the country. You and I can talk again to really move on this issue. But I believe that we have got a momentum going. Both at HUD and through your hearings, we really are able to work on it.

Madam Senator, I invite you to come to Baltimore sometime because we are work in progress. We have not solved our problems, but we have got everybody on the edge of their chair now working to solve the problems, to protect the poor, to protect the taxpayer, and to protect the neighborhoods. And, after all, that is what the U.S. Government, as big as it is, should be able to do.

So we thank you for your leadership and look forward to working with you.

Senator COLLINS. Thank you very much, Senator. I am, as always, very impressed with the dedication and the amount of work you have done on this very important issue. Without your leader-

[1] See Exhibit No. 2 which appears in the Appendix on page 117.

ship, we never would have had this report. We will put it in our hearing record so that all may have the advantage of it, and I really commend you your leadership.

We have a series of two votes on now. I am going to recess the hearing for about 15 minutes, and then I will come back and we will swear in our next panel.

Senator MIKULSKI. Good, and I really look forward to working with you because, I tell you, I think if we had a bipartisan effort here, we can really get to the bottom of it. And hats off, I might say, to the U.S. Attorney, the FBI, and the postal inspectors. They were the first to do the indictments that then were the early warnings here. So I look forward to working with you.

Senator COLLINS. Thank you very much.

The hearing will stand in recess for 15 minutes.

[Recess.]

Senator COLLINS. The Subcommittee will come to order. I apologize for the delay that has occurred because of the vote.

Our second panel of witnesses consists of homebuyers who were the victims of property flipping schemes. Each of these witnesses is a first-time homebuyer who purchased supposedly rehabilitated properties after obtaining mortgages insured by the Federal Housing Administration. Each of them, however, was victimized by sellers who grossly inflated the value of the properties and failed to rehabilitate the homes as promised.

First, the Subcommittee will hear from Lisa Smith, who lives in Fresh Meadows, New York. Ms. Smith is a New York City policewoman.

She will be followed by Sonia Pratts, who lives in Hollywood, Florida. Ms. Pratts works as a health care assistant.

Finally, we will hear from Stekeena Rollins, who resides in Chicago, Illinois, and provides day-care services at a preschool in Chicago.

I want to thank all of you for being willing to come forward and tell your stories. I know it is not easy to talk about what has been an absolutely horrible experience for each of you. But by doing so, you will help prevent other people from being victims of the kinds of schemes that unfortunately were perpetrated on you. And you will also be helping us formulate public policy to try to prevent this from happening to others.

So I know it is hard for you to tell your personal stories in a lot of ways, but you are doing a wonderful service by doing so. And I just want to personally express my thanks and the thanks of the U.S. Senate for your willingness to come forward.

Under the Subcommittee's rules, all witnesses are required to be sworn in, so I am going to ask that you all rise and raise your right hand, and I will swear you in.

Do you swear that the testimony you are about to give to the Subcommittee will be the truth, the whole truth, and nothing but the truth, so help you, God?

Ms. SMITH. I do.

Ms. PRATTS. I do.

Ms. ROLLINS. I do.

Senator COLLINS. Thank you.

You will see that we are going to be using a timing system. That is just to help you gauge the length of your remarks. When you see an orange light come on, it is time for you to start summing up, and when you see a red light start flashing at you, you could please conclude your comments. But we are not going to be real strict about it, so if you have something that you think you need to say to us, feel free to continue. And we will put your written testimony in the record in its entirety.

Ms. Smith, we are going to start with you.

**TESTIMONY OF LISA SMITH,[1] FRESH MEADOWS, NEW YORK**

Ms. SMITH. Good morning. My name is Lisa Smith. I am a single mother of three children and a police officer with the New York City Police Department.

Senator COLLINS. Ms. Smith, excuse me for interrupting you. These mikes are a little bit tricky, so if you could make sure—I think it is a little high for you, right.

Ms. SMITH. In February 1997, I decided that I wanted to buy a house for my family. At the time, we were living in a two-bedroom apartment that was very small and all the children had to share one bedroom. I knew they needed their own personal space, and it would be a dream come true if they could have their own bedroom. I had recently ended a personal relationship that had been hard on the whole family, and I thought it would give me a sense of independence to be a single mother buying my own home. I knew it would not be easy, but I had no idea about the terrible experience I was about to go through.

One day in April 1997, while looking through a newspaper ad, I saw a real estate ad that caught my eye. The name of the company that had placed the ad was Lenders Realty in Brooklyn, New York. The ad caught my eye because it said that the houses were completely renovated and all the closing costs were paid and only a low down payment was required. I thought that was great and called Lenders. Two women from the company came to my apartment. They were very nice and made me feel comfortable. They told me that all the houses they sold were foreclosures. I didn't understand what that meant, and they explained to me that the banks own the houses. I told them what I was looking for and the price range I could afford. They told me not to worry and said that they would make sure I got a good house that was in my price range.

They took me to a house in South Ozone Park and explained that the house was completely renovated. In early May, we went to see the house. They said that if I liked it, all I had to do was move in. I stood outside and looked at the yellow and brown house. It appeared to be well-kept and looked nice. My heart was beating fast, and I had a big smile on my face. I had to get myself together before I went into what would probably be my house. When I went inside, I was so excited. It seemed like it had been renovated, and it looked new. I was the happiest person in the world that day. They saw the excitement on my face and said the house was mine if I wanted it.

[1] The prepared statement of Ms. Smith appears in the Appendix on page 77.

I asked about the roof because it looked like it had fresh black tar on it. They told that the roof was new, and so were the kitchen, bathrooms, bedrooms, and windows. They also explained that if there were any problems with the house, they would be repaired before I moved in. I told them I wanted the house but wasn't sure if I would be approved for a mortgage. They explained that I shouldn't worry and said that they would help me get a loan. They then told me if I wanted the house, I had to enter into a contract. I didn't know what that meant either, so they explained to me that the process of buying a house and getting a mortgage began with my signing a contract to agree to buy the house. They said I had to go right back to Brooklyn with them so the paperwork would start. They explained that the house would sell fast if I didn't buy it quickly. I couldn't understand why there was a big rush, but I trusted them.

We went back to Lenders Realty office, and a supervisor, a woman, told me I should be so proud to have a house for my family. I explained that I needed to call a lawyer since my job would provide me with free legal services. She told me that it wasn't necessary because Lenders would provide a lawyer for me. I called the PBA lawyer anyway, and he told me that after the contract was written, I should fax it over to him and he would review it. I told the Lenders supervisor that, and she seemed not to be very happy. She later told me that she had talked to the PBA lawyer and that I shouldn't use him because he had made me sound stupid and incapable of making any decisions. She also told me that I didn't deserve a lawyer that was going to bad-mouth me. She told me that I should use their lawyer and that he was a very good lawyer and would be acting on my best interest. If I had to do this again, I would have conferred with this lawyer, and he would have never allowed me to sign this contract. She also told me that the Lenders would arrange for my mortgage and they would take care of everything. I never knew things moved so fast when buying a house, and I started to feel pressured. But I trusted her.

In July 1997, we closed on the house. There was so much paperwork to fill out. I was really nervous because there was so much I didn't understand. I had called the lawyer before the closing, and he told me not to worry and said that everything would be OK. Then at the closing, the lawyer hardly talked to me. When I tried to read the papers, he told me just to sign the papers. If I asked a question, he barely answered. Then after 2 hours it was over. The house was mine. I paid $129,000.

The day I moved in was the best day in the world. My children were so excited, and they ran into the house to look at their bedrooms. But shortly after that, my problems with the house started. In August, water started to leak from the light fixture in my ceiling into my bedroom. I called a friend who was a licensed electrician to come look at the ceiling. He went to the roof and noticed that there was tar on the roof and explained that there was a weak spot on the roof that needed more tar. He told me that he didn't know what was under the tar or how bad the situation was. He put more tar on the roof, and it seemed to work for a while.

In September 1997, I couldn't understand why the basement floor and stairs were so weak that it felt like you would fall right through the floor. Again, I had my friend come to the house and pull up the tile from the floor. I couldn't believe what I saw. There was a huge hole that had never been repaired. It had just been covered over with tile. I couldn't understand how someone could put other people at risk of serious injury by simply putting tile over such a big hole. Lenders had told me that they had paid an inspector to look at the house, and the inspector found that the house was in good and safe condition. I started to get kind of scared, but I kept remembering that Lenders had promised to take care of everything.

Shortly after I moved in, I began experiencing plumbing problems. I called the New York City Department of Environmental Protection to complain about flooding. I also found out from a neighbor that the house had a long history of water problems and had received numerous citations from the city. Whenever we turned on the water, the pipes sounded like they would explode. On top of that, the house began to shake, and I found out that the water from the upstairs bathroom was leaking down into the dining room. I couldn't afford to make all the repairs on the house, so I had to take out a second mortgage for approximately $12,000. I was now paying $1,028 per month on my original mortgage and $368 per month on the second. I struggled to make the payments and was never late.

Then in June 1999, the upstairs bathroom started to have plumbing problems, and water leaked all over my kitchen and dining room. I had a flood in the basement, and all my children's summer clothes were ruined. The smell in the basement was terrible because the sewage was backed up. As you can see from the photographs of the house, sewage backed up everywhere. I found more holes in the floor and I was really upset. I knew one of the children could be hurt and that it had to be repaired. I couldn't afford to make more repairs, so I had to take out a third mortgage for the house for $45,000. The third mortgage cost me close to $600 per month, but I continued to make all the payments.

When the weather began to get cold, the house was freezing. I would turn the thermostat up to 80 degrees, but it would still read 45 to 50. There were nights when it was so cold in the house that I took my children to a motel. Even though I had two comforters on the beds, the children started to get sick. When the flooding began in the winter, I couldn't take it anymore.

For a long time, I thought about the house and about my family's safety and health. I realized the house was falling apart, and I couldn't afford to make all the mortgage payments. It was costing me nearly $2,000 a month, and the condition of the house wasn't improving. So in January 2000, I decided that as much as I didn't want to give up the house, I had to let it go. It saddened me much because even with the problems, I loved the house. Over the past few years, I had worked so hard to pay my bills on time and get good credit. But I had to declare bankruptcy and eventually lost my house. What makes it worse is that I have since learned that the owner of the house only paid $50,000 in December 1996 and then resold it to me 7 months later for $129,000.

I hope this never happens to anyone else. Although my credit has been totally destroyed, I feel so much better that I left the house.

I would never have forgiven myself if someone had been seriously hurt in the house. I have learned that in the future, regardless of what anyone tells me, I will read everything and ask questions. I hope that the people who took advantage of me will learn a lesson, too. I pray that I can overcome my bitterness that this experience has created, but I also know this has made me a stronger person.

I would be happy to answer any questions the Subcommittee may have.

Senator COLLINS. Ms. Smith, my heart just aches for you, and I am so sorry that you have endured this, and it is so unfair that you have had to go through this. We are going to help you in every way that we can.

I do have some questions I want to ask you, but we are going to hear from the other two witnesses first. But I just want you to know that I am just so sorry that you have had to go through this. It really has been a nightmare for you, I know.

Ms. Pratts, would you proceed, please?

## TESTIMONY OF SONIA PRATTS,[1] HOLLYWOOD, FLORIDA

Ms. PRATTS. Good morning. My name is Sonia Pratts. I live in Hollywood, Florida. I am currently employed as an assistant manager at Memorial Senior Resource Center in Pembroke Pines, Florida. I would like to thank you for inviting me here today to tell my story.

Two years ago, my husband Carlos and I began driving through various neighborhoods in South Florida looking to purchase our first home. Neither he nor I had ever owned a home. It was our dream to have a home of our own, a place large enough for my kids. We were not looking for luxury, but we wanted a comfortable home with no problems. We had been saving for over 2 years to buy our dream home.

In October 1997, we were driving through several neighborhoods looking at houses for sale when we stopped at an open house sponsored by ERA Homeland Realty. After we looked through the house, we spoke with the real estate agent. We told him that we really liked the house, but he told us that it was out of our price range and showed us a second house located at 6121 Jackson Street, Hollywood, Florida. He then introduced us to his boss, Joe Kuruvila, a real estate broker, who told us he would like to take care of us.

The first time we looked at the house on Jackson Street it was late at night. The second time was during the day, and we could tell it was being worked on. The back room was torn apart, and the front room was a mess and lots of garbage around. There was a big dumpster full of trash in the front yard. We were concerned about the house because of all the work it needed. We told Joe that we did not want a house that we would have to spend money making repairs on because we were using our entire savings for the down payment. Joe told us that the house had a new roof and was insulated. Additionally, he told us that the entire house would have new windows, new doors, and the walls would be as good as new. He also told us that we would be able to afford the mortgage pay-

[1] The prepared statement of Ms. Pratts appears in the Appendix on page 80.

ment for the house on our income. We foolishly trusted Joe and signed a contract to buy the house.

One day after we signed the contract, my husband Carlos drove by to check on the progress of the rehabilitation work being done on the house. As he approached the house, he saw a code violation notice taped to the house. He went straight to Joe's office and asked him about the violation notice. He assured him not to worry and said that everything would be taken care of before we moved into the house. We did not get a home inspection because of the promise from Joe that the house would be as good as new when we took it over.

Joe recommended that we get our mortgage at Hollywood Mortgage. We followed his advice, and through Hollywood Mortgage we got a loan with something called a "buydown," which I still don't understand exactly what this means, but I do know that we had told Joe about our tight financial situation, and he assured us that under the buydown we would be able to afford our mortgage payment.

On February 20, 1998, we went to Joe's office for the closing. Present in addition to Carlos and I was Joe and a representative from the title company, Gerald Chapman. We did not have a lawyer of our own because Joe told us that he would take care of everything. When we finished with the closing, we were very excited. We were homeowners. Little did we know what was in store for us.

We moved into the house in February 1998. Approximately 2 months later, to my shock, I received a notice of code violations from the city of Hollywood. The violations included lack of permits for windows and the addition to the house. The notice required all items to be replaced or fixed. If we failed to do so, we would face a fine of up to $200 per day from the city.

The electrical system in the living room is wired wrong. We have sockets that did not work and are not hooked up. I am concerned that this faulty electrical system will cause a fire. The rotted wood in the front room is all that holds the windows in place, and continues to fall apart. We have had so many problems with the house. It seems to be falling down around us. The living room walls are in terrible shape, and the ceilings are crumbling. As you can see from these photographs,[1] there is termite damage throughout the house. Mice and rats enter the house through holes and, because of a lack of foundation, under the addition in the back.

The roof is another story. As you can see from this photograph, the roof is falling down and leaking. Recently we had a storm last week, and that part back there that you see—the roof fell. It needs to be repaired and insulated. Joe had told us that the house would have a new roof, and, in fact, I later found out that the roof was listed on the appraisal as new. Believe me, the roof is not new. The roof leaks every time it rains. We also have birds getting into the house and rats crawling around. We can hear them running around at night.

The appraisal also refers to other repairs that were never done. For example, the appraisal stated that the rotted fascia and soffits were repaired. That was not done. It also said that all the debris

[1] See Exhibit No. 5.a. which appears in the Appendix on page 178.

was removed from the yard, and that was not done. Carlos and I worked to clean up all the garbage left behind. From my understanding, the appraisal was used to determine the value of my house. I am not an expert, but I don't understand how this can be when so many things listed in the appraisals were not true. I also don't understand why I was never given a copy of the appraisal before closing.

After closing, we contacted an engineer to look at the house in the hope that we could fix the problems we were having. The engineer told us that the total cost of repairs would be approximately $40,000 and that the majority of the house would have to be demolished. So, in other words, if you demolish three-fourths of the house that has to be torn down to put it on code, then the rest of the house won't be on code; so he told us that the whole entire house would have to be demolished to be on code.

When I heard this, I was devastated. We simply don't have the money to spend repairing the house, remedying the code violations we were stuck with, and making our mortgage payments. Because of this buydown mortgage that we were given, our payment has ballooned up by more than $200. I am worried that we will lose our house because we are really struggling to make ends meet.

We later learned that Joe Kuruvila owned not only the real estate agency that sold us the house, but also our mortgage lender and even the house itself. We have also learned that Joe bought the house from HUD in September 1997 for $44,600 before he sold it to us in February 1998 for $80,000. In just 6 months, he nearly doubled his money. From what I can tell, Joe bought the house, made minimal cosmetic repairs, and then sold it to us without disclosing the hidden defects. I trusted him because he told us that he would make our dream of owning a home come true, and he said that he would take care of us. Little did I know that he was holding all the cards.

We spent about a year asking Joe to correct the code violations and complaining about the condition of our house, and all we heard in response were promises to make things right, but we never saw any action. Although we did not want to involve the courts, we felt we had little choice but to file a lawsuit against him seeking compensation. Our church is paying our legal fees, and the suit is presently pending in Broward County Circuit court. We have also discussed our problems with the State of Florida.

My life and my husband's life have been devastated. At present, we are just getting by on our paychecks and could never hope to make the needed repairs or pay a fine. My husband and I have been severely damaged by all of this. Our lives are in turmoil, and my marriage is deeply hurt. What was once my dream home is now a nightmare.

I will be pleased to answer any questions of the Subcommittee. Thank you for giving me the opportunity to tell my story.

Senator COLLINS. Ms. Pratts, again, I want to thank you for telling your story. I know this has been such a painful experience for you, as it has been for Ms. Smith. And it is just so wrong that this has happened to you, to all three of you. It makes me so angry. And that is why we are holding this hearing today, and I know it is so hard to tell your stories, but you are really helping others avoid what happened to you.

Ms. PRATTS. Yes. This situation is very critical because my husband is a schizophrenic, and he has tried to take his life already three times. My husband is the kind of person that he can't deal with problems. It affects him very, very much, and I tried to call him yesterday. I was really worried. I had to call him this morning, and he didn't sound too well on the phone. So I just hope that something will come of this.

Senator COLLINS. Thank you.

Ms. Rollins, before I turn to you, I want to acknowledge that Senator Durbin, who is your Senator, has joined us. He has been working very hard on this problem as well, and I know he is extremely concerned about the flipping problems that we have identified in Chicago. He has worked very hard on this, and I know he wanted to be here today specifically to hear your testimony as well as the others. So if you would please proceed?

## TESTIMONY OF STEKEENA ROLLINS,[1] CHICAGO, ILLINOIS

Ms. ROLLINS. Good morning. My name is Stekeena Rollins. I live in the Austin neighborhood of Chicago, Illinois, and I teach preschool children.

In mid-1995, my mother, Shirley Rollins, and I read an advertisement in the *Chicago Sun Times* that said "Kiss Your Landlord Good-bye." The ad offered rehabilitated homes for sale with low down payments from a company called Easy Life Real Estate System. At the time, I was 20 years old and living on the northern side of Chicago in an apartment. Neither my mother nor I had ever owned a home. I was operating a day-care business from my apartment, which I was interested in moving to a home setting.

We felt we could afford the down payment mentioned in the ad. So in June 1995, my mother and I visited the Easy Life office and met with the sales agent, Peter Sandow. Mr. Sandow told us that Easy Life was offering 100 percent "rehabbed" homes to first-time homebuyers through a special government program called FHA. He told us that through this program our down payment would only be $500. He asked us some other questions about our jobs and how much rent we paid. He told us he would get back in touch with us.

About a week later, we had another meeting with Mr. Sandow. He showed us a contract that had no address and told us to sign it so that we could get the ball rolling. We signed the contract. The price on the contract was $119,000, but Mr. Sandow told us that was just a rough draft. This is the price we paid for the house. I have recently learned that Easy Life purchased the home for $14,000 in May 1995.

He showed us some pictures of homes and then took us to see some of them. They were in terrible neighborhoods, surrounded by abandoned houses. We told him we didn't like the areas and that we wanted to buy a home on the north side so that my day-care clients could be close. Mr. Sandow told us that Easy Life does not have any homes for sale on the north side, but asked if we were interested in buying a home in Oak Park. I thought that my clients

[1] The prepared statement of Ms. Rollins appears in the Appendix on page 83.

would come to Oak Park, a suburb just west of Chicago, so we said yes.

Mr. Sandow drove us to the house he said was in Oak Park. It was visibly fire-damaged and had been abandoned for some time. It was completely gutted and was under construction. Mr. Sandow told us many parts of the house were too unsafe for us to see, but it looked fairly large. We thought it would work well for my day-care business. When I pointed out to him the crumbling walkway, the holes in the foundation, and the unstable foundation supporting the back porch, he again told us that the house would be totally rehabbed and that everything would be new by the time we moved in. I explained to Mr. Sandow that the first floor would need to be modified to meet State licensing requirements for a day-care business. He said that would be no problem. In fact, he even met with a State day-care licensing representative to discuss the requirements for modifying the house. We were very excited and thought our dreams were coming true.

We saw the house again with Mr. Sandow in mid-July. On this visit we saw the basement for the first time. My mom told Mr. Sandow that we would need another bedroom in the basement. He said that it would be taken care of. On the second floor, we saw the stairs were cut too steep going up into the third floor and that the ceiling on the third floor was very low. I asked Mr. Sandow if he could change the ceiling so that we could use the third floor for bedrooms. I also asked him to fix the stairs so that they wouldn't be such a hazard. He said it would be no problem.

After that, I tried to go back to the house several times, but the house sitter who was staying there would not let me in. Other times the workmen wouldn't let us in. When we asked Mr. Sandow about it, he told us that everything was going fine and not to worry.

About a month before the closing, we found out from a family friend familiar with the west side that the house was not in Oak Park as Mr. Sandow had told us. Instead, the house was located in the Austin neighborhood of Chicago. My mother and I were very upset and confronted Mr. Sandow. He admitted that the house was not in Oak Park, but he told us that it was too late to back out now.

Before the closing, Mr. Sandow told us that he had found a company that was willing to give us a loan. We met the gentleman from Dependable Mortgage at Easy Life's office. He told us that all we had to do is fill out some paperwork and everything would be fine. Neither he nor anybody else explained to us we would have an adjustable rate mortgage. In fact, at the time we did not know what an adjustable rate mortgage was and had no idea that our mortgage could increase.

Also, before the closing, my mother asked Mr. Sandow if we needed to do anything else. Mr. Sandow told us that, as part of the special government program, Easy Life would supply a lawyer to represent us, conduct a home inspection for us, and have termite control specialists examine the house. At the closing in September 1995, the Easy Life lawyer gave us a lot of papers to sign, but he didn't explain anything about them. He seemed to be in a hurry and said he had a boat to catch. We didn't understand everything we were signing, but we trusted the lawyer and signed the papers anyway.

We moved into the house about 1 week later. I noticed right away that Easy Life had not done the work required for my day-care license. When I called Mr. Sandow to complain, he said, "Don't worry, go ahead and move in and we'll work around you." I kept calling Mr. Sandow, but the modifications were never made, and I was never able to get my day-care license.

We soon began noticing other problems with the house. As you can see from these photographs, the house has a dangerous furnace which has resulted in numerous instances of overheating and burn-outs of the gas regulator, a narrow and dangerous stairway to the basement, an overloaded and leaky roof with three or more layers, a garage that is leaning severely and is unstable—unusable, a damaged ceiling in the first-floor bedroom from a constantly leaking toilet, a second-floor deck that is improperly nailed through the roof, and the poor ceramic tile that has come loose. Underneath the cheap carpets Easy Life installed were the same burnt wooden floors that I had seen the first time when I looked at the house. In addition, the walkways that Mr. Sandow had promised to repair were crumbling, and the foundation under the back porch was still unstable. The floors in some areas of the house didn't meet the walls, which allowed rain and snow to enter the house. The light sockets sparked and the toilets overflowed.

I complained about ten different times to Easy Life about the problems in the house. In response, Easy Life sent some workmen to the house on several occasions. They did some caulking, nailed down the front steps, and put a patch on the second floor toilet, and installed a ventilation system in the attic. But the work that they did only lasted 1 or 2 days, and then the problems would come right back.

We have had many other problems with the house since we moved in. The representatives from the gas company have come out to the home several times because of leaks in the furnace. They had to disconnect the gas and the piping, and they told us that the piping was old and improperly attached. They also told us that the furnace is unsafe. We have seen termites swarming, the plumbing leaks, and the garage is leaning heavily to one side. The windows were improperly installed and there is no insulation. Instead, as you can see from the photograph,[1] cheap new siding was installed over the burned wooden exterior, so cold air comes right through into the house in the winter.

My mother and I have tried our best to make the repairs, but cannot afford to put the kind of money into the house that it needs to make everything right. I estimate that we have spent several thousand dollars of our own money to keep the house from falling apart. We have not been able to keep up our mortgage payments because they kept going up. Right now there is a foreclosure case pending against us, and we are afraid of losing our house.

I appreciate the opportunity to tell my story here today. I will be glad to answer any questions the Subcommittee has.

[1] See Exhibit No. 3.a. which appears in the Appendix on page 169.

I would also like to state that Ms. Gladys Hall is also a member of the same neighborhood that I live in. We also purchased the same home from Easy Life Real Estate. I would also again like to thank Counsel Nina Vinik for allowing me to have this opportunity to come here today and to state the problems not only that Chicago is having but that faces many different cities in the United States. I would like to say to Senator Durbin, I know that you have been working with us, and I know that this is going to take time. But, please keep us in mind. We will do everything that we can to support you in helping other cities, not only just Chicago, to get this problem resolved. Easy Life has devastated Chicago, not just South Austin, but devastated Chicago and its entities.

Thank you.

Senator COLLINS. Thank you, Ms. Rollins. You were very eloquent in describing what happened to you and how your dream of opening the day-care center turned out to be a nightmare as well.

I just want to clarify on the one last photo. This is your mother. Is that correct?

Ms. ROLLINS. Yes.

Senator COLLINS. And she was involved in buying the house with you.

Ms. ROLLINS. Yes.

Senator COLLINS. Before I go to questions, I want to call upon Senator Durbin for any opening comments that he might want to have.

## OPENING STATEMENT OF SENATOR DURBIN

Senator DURBIN. Thank you, Madam Chairman, and I am going to be brief because I want to ask a few questions, as I am sure you do, too. But first let me compliment the Chairman of the Subcommittee, Senator Collins. This Subcommittee is such a breath of fresh air. We bring stories before us here that are troubling, upsetting, but it is the real world. And, unfortunately, too many times in Congress we entertain people in nice suits, high rollers who come and tell us stories based on statistics and theories and don't bring real families and real concerns before this Congress. This Subcommittee is a notable exception, and I want to congratulate Chairman Collins for this hearing and for gathering these witnesses, who really tell us a story that everyone in Congress should hear.

Ms. Smith, thank you for being here, and as a New York police officer, you are doing your duty to your city, and you never should have gone through this experience.

Ms. Pratts, as you talked about the family circumstances that you are facing, with the health problems, it is amazing that you can make it through this ordeal, but to have that on top of it is a tribute to your strength. Thank you for being here.

And, Ms. Rollins, thank you for coming and telling the story from the Chicago perspective. I am glad to hear that you are working with the South Austin Coalition Community Council. This is a good group. They really fight for people. And I have worked with them in the past on a lot of different issues like LIHEAP and energy assistance.

I want to say in my opening statement that this hearing is about government letting people down. That is what this is about. It is about the Department of Housing and Urban Development, as the GAO report spells out, failing to keep an eye on these lenders who are taking advantage of innocent people, like Ms. Rollins, who, with her mother, had a dream of owning a home for the first time in their lives and saw this dream disintegrate.

FHA needs to do a better job of keeping businesses like Easy Life off the street. We have got to get rid of these loan leeches and real estate reptiles that are out there taking advantage of ordinary people. And that means that HUD has to do a better job, and we have to hold them to a higher standard. And though they may be improving their situation, they can still do a better job.

I will join Senator Collins in a bipartisan plea and demand, if you will, that HUD do a better job of policing the ranks of people who sell these homes and finance these homes.

Now, there is another failure of government involved here, too. What we are seeing before this Subcommittee today in this panel are people who are right on the edge of bankruptcy. Ms. Smith, if I am not mistaken, you indicated that you filed for bankruptcy already.

Ms. SMITH. Yes.

Senator DURBIN. I don't know the situation of Ms. Pratts and Ms. Rollins, but you can understand with foreclosure proceedings being filed what they could face.

We debate the bankruptcy law in theory, about people who are abusing the bankruptcy court. Listen to these stores, real-life stories of people on the edge headed to the bankruptcy court. I hope the other two of our witnesses can avoid it. But that ought to be a reminder to all of us that this bankruptcy debate we have been in for years is about people just like those who have joined us today.

Last November, I introduced an amendment on the floor of the U.S. Senate, and this is what it said: Predatory lenders who deceive people like the three who have gathered before us today into signing documents that they could never honor nor deal with balloon payments and worthless pieces of real estate, should not have the protection of the bankruptcy court. These lenders should not be able to walk into bankruptcy court and demand from these three families full payment for their deceptive loans. I think the courts ought to close the doors to those folks. They have violated the law. They shouldn't have the protection of the bankruptcy court to collect.

You know what? I lost that amendment. The vote was 51–47. I couldn't get a majority in the U.S. Senate to agree with me that those predatory lenders have no place there. And the group that opposed me was the other lenders and the other banks who said, well, we don't want to get the government involved in credit practices.

Listen to these stories and tell me that government shouldn't be involved in keeping an eye on these predatory lenders. I just wish my colleagues in the Senate could be here with Senator Collins and myself today to hear these stories. We might have had a different result on that bankruptcy amendment on predatory lending.

Thank you, Madam Chair.

Senator COLLINS. Thank you, Senator Durbin.

Ms. Smith, I would like to ask you a few more questions, and I would like to ask the staff to put up the picture of the toilet from Ms. Smith's house.[1]

From the photographs we have seen of your house—and we have seen many of them—you have obviously experienced very severe problems. And I just want to make sure I understand what I am seeing in this photograph. It looks to me like raw sewage is coming up out of the toilet and spilling out all over the floor. Is that what I am seeing here?

Ms. SMITH. Yes. What it was, when you flushed the toilet from upstairs, it would come out of the toilet from the basement.

Senator COLLINS. My staff visited your house, as you are well aware, and they said the stench from this was just overwhelming. There was no way anyone could live in your house. And in addition to being unpleasant, it is obviously a safety hazard.

Ms. SMITH. Yes.

Senator COLLINS. Was that part of your concern about having your children living there?

Ms. SMITH. Yes, because at the time my son—I had made him a nice room in the basement—so I had to move him out of the basement because we started getting a lot of mold and the flooding, the feces all over the place. So I had to move the kids, everyone upstairs.

Senator COLLINS. Did you ever talk to anyone about making repairs on this problem?

Ms. SMITH. I had spoken to Lenders, and basically they weren't any help to me. They were OK in the beginning when they knew I was excited about the house. But once the problems started, I was on my own.

Senator COLLINS. And this was despite the fact that the sales contract that you signed said that the seller would make all necessary repairs. Is that right?

Ms. SMITH. Yes.

Senator COLLINS. So you essentially were lied to, weren't you?

Ms. SMITH. Yes.

Senator COLLINS. You were deceived about the condition of the house, and then when it became obvious that very major repairs were needed to make it fit for you and your family to live there, they refused to make the repairs. Is that right?

Ms. SMITH. Yes.

Senator COLLINS. Now, it is my understanding you did talk to a contractor about this particular plumbing problem, and what were you told? Were you told that it was something that could easily be fixed? Or was it a major problem?

Ms. SMITH. He said it was a major problem. Basically they would have to gut it, gut the whole basement, the walls, everything. Everything was behind the walls. And it would cost me a lot of money to have it fixed.

Senator COLLINS. We also have some pictures of your house—and I don't know whether we have them with us or not—of the windows

[1] See Exhibit No. 4.a. which appears in the Appendix on page 176.

and the doors with plastic over them. Obviously you were trying to keep out the cold. You said it was cold, even though you turned up the thermostat to 85. Did you ever find out whether the home was insulated?

Ms. SMITH. Well, what happened was, with one of the home improvements, they had took down some of the siding, and there was no insulation at all. It was just wood there.

Senator COLLINS. Were you also concerned about the safety of your children because of the problems you told me about with the holes being discovered when you peeled back the floor?

Ms. SMITH. Yes.

Senator COLLINS. What was your concern?

Ms. SMITH. Well, with the holes that was in the floor, you could either break a leg, the hole that was leading to the basement, we could have fell through the floor, that is how big it was.

Senator COLLINS. That is extraordinary, and that was concealed, deliberately concealed by the placement of the tile over the hole.

Ms. SMITH. Yes, just tile.

Senator COLLINS. Now, you testified that you felt as though you were being rushed through the whole process, and that you were discouraged from asking any questions. Is that correct?

Ms. SMITH. Yes.

Senator COLLINS. What was your concern? Were you concerned that you would lose the house. Did they give you the impression that if you didn't act now, someone else was going to snap up what appeared to be a good house?

Ms. SMITH. Well, basically they said that the houses go fast, this is a great buy, I am getting a good price on the house, and this is my house and they wanted to make sure that I get this house.

Senator COLLINS. And I understand that you decided to not have a home inspection of the house, which would have revealed a lot of these problems. Why did you decide not to get the home inspected before you bought it?

Ms. SMITH. Well, basically they had told me, Don't worry, everything is OK, and that they had the house inspected, and that they would never let me move into a house that was unsafe.

Senator COLLINS. So you thought it was pointless to pay for a home inspection because you had been told by Lenders Realty that it already had been inspected and it was fine. Is that a fair statement?

Ms. SMITH. Yes.

Senator COLLINS. So you thought, well, why bother to pay for a second inspection?

Ms. SMITH. Right.

Senator COLLINS. How did you select the bank for your mortgage?

Ms. SMITH. I didn't select a bank. Lenders selected the bank.

Senator COLLINS. And they told you they would take care of everything, and just as they made the false assurances that if there were any repairs necessary, they would take care of those as well?

Ms. SMITH. Yes.

Senator COLLINS. When you bought the house for $129,000, did you have any idea that just 7 months earlier the seller had purchased it for $50,000?

Ms. SMITH. No, not at all.

Senator COLLINS. Was it our staff who told you that for the first time?

Ms. SMITH. Yes, and I was devastated.

Senator COLLINS. So had you known that just 7 months earlier this house had been purchased for less than half of what you paid for it, would that have been a red flag to you?

Ms. SMITH. Yes. I wouldn't have bought it.

Senator COLLINS. Ms. Smith, just one final question for you. You have testified that you had no choice but to default on the mortgage. You obviously couldn't afford all those repairs. It has been an awful experience for you. Are you living in an apartment now? Have you moved back into rental housing, or what are you doing now?

Ms. SMITH. Rental housing.

Senator COLLINS. And you have had to file bankruptcy. How has this horrible experience affected you and your family?

Ms. SMITH. A lot of stress. I mean, I am back to square one. I had a house that I wanted for my children, and now I am back in an apartment again, and they are back sharing one bedroom. And it is hard, but at least I could say that they are safe and they are happy.

Senator COLLINS. I thank you again very much for coming forward. It is so awful that you were deceived in this way, and I can imagine your joy at owning a home and having what appeared to be a wonderful new home for your children, only to have it end this way. And, again, we will help you in every way that we can.

One of the actions I am going to take is to ask HUD what they are doing not only to assist you personally but also to take action against the people involved in the flipping scheme that has affected you so detrimentally.

Ms. Pratts, I understand that you also decided not to get a home inspection before you bought your home. Can you explain to us why you didn't get the inspection?

Ms. PRATTS. When we went to see Joe Kuruvila, my husband and I, we asked him if we had to do anything for the house, and he said no, that he would take care of it: "Because you are a first-time buyer, we are going to take care of everything for you." So that is the reason why we didn't get a home inspector or anything like that.

Senator COLLINS. So you thought everything had been taken care of, you received all these assurances, and you testified that you specifically told the seller that this was a stretch for you financially, that you had saved and saved in order to come up with the down payment that you needed, and that you didn't want a house that needed a lot of repairs. Is that correct?

Ms. PRATTS. Exactly. Even my husband told him, we came here, I am glad you showed us the house, we came here not only for that but I want to make sure that we don't have to spend any money on the house or anything because we can't afford it. And, actually, we did spend money on the house. We still have the receipt from Home Depot, $2,500 that we already spent so far. The rest we couldn't pay for or fix or anything because we can't afford it.

Senator COLLINS. So you made it really clear that you weren't looking for a fixer-upper where you would have to spend a lot of money to renovate the house.

Ms. PRATTS. Exactly.

Senator COLLINS. Because you were using all of your savings in order to afford the down payment and get into the house. Is that right?

Ms. PRATTS. Exactly.

Senator COLLINS. And, once again, I want to emphasize that you were told by the seller that the house would be completely renovated, and indeed, it appeared renovations were going on. Is that accurate?

Ms. PRATTS. Yes. He was fixing the house, all right, but he was fixing it with people that didn't have a license or building permit or anything at all whatsoever. That is how the violation came up, and then more of the violations came up. This house had violations since 1982.

Senator COLLINS. You are talking about code violations, correct?

Ms. PRATTS. Yes.

Senator COLLINS. So when you moved into the house, you find out there are all these problems, you actually get a notice of code violations, for which you personally were going to be fined, is that right?

Ms. PRATTS. Yes.

Senator COLLINS. So what happened? Did you confront the seller? Did you go back—could you talk a little bit about that?

Ms. PRATTS. We went over to him, and we asked him about all these violations, and he said that he would take care of it. And we went a couple of times to take care of it. It so happens that I myself went into an investigation to see how in the heck did we get this loan. And when I went to investigate, that house did not have termite inspection, roof inspection, or anything at all whatsoever.

Senator COLLINS. So none of what you had been promised was done.

Ms. PRATTS. No.

Senator COLLINS. And you obviously trusted the seller that not only was the house completely rehabilitated but that he would take care of the code violations and any other problems?

Ms. PRATTS. Yes.

Senator COLLINS. Let me ask you one more question before turning to Senator Durbin for his questions, and then I will come back to Ms. Rollins for some questions that I have for her. It is similar to the question that I asked Ms. Smith. At the time that you bought the house—and you paid, I think, $80,000 for it? Is that correct, was it $80,000?

Ms. PRATTS. Yes.

Senator COLLINS. Did you have any idea that Joe Kuruvila had paid only $44,600 for the house just 5 months before?

Ms. PRATTS. I didn't know any of that at all whatsoever, but my son, when he came from New York—he was transferred here—he said, Mom, we could find out how much that house cost.

So my daughter-in-law's cousin, he is a realtor, he looked it up on the Internet, and when I saw the price, I nearly had a heart attack. In fact, my husband was so upset, he went over to the office and told him a thing or two. And he promised us so many things, and then I said, you know what? We are going to take care of it. So that is how we got our lawyer, through our church, and so up to this date, they are taking care of it.

Senator COLLINS. So had you known that it was being sold to you for almost double the price just 5 months later, you never would have bought the house?

Ms. PRATTS. I wouldn't have bought it.

Senator COLLINS. Senator Durbin.

Senator DURBIN. Thank you, Madam Chair.

I think some of your questions and answers really make it clear what a cruel experience you have been through. If I am not mistaken, this was your first homeownership experience, something you had never been through this before, and you didn't quite know what you were getting into. You were pushed to the limit on payments by people who were trying to get you to sign these contracts and clearly were deceived in terms of the product that you were trying to purchase.

I would like to ask a few questions, if I could, of Ms. Rollins. Is Easy Life Real Estate still in business?

Ms. ROLLINS. No. They have since moved on, and they have started other companies. That is why I stated earlier it is entities because they have moved on to other companies and use different names. Same tactics, different name.

Senator DURBIN. But are they still around? I mean, could you pick out the people that are still involved in this?

Ms. ROLLINS. As far as the real estate agents, to my knowledge, some of them have moved on and started their own development projects. The real estate agent that sold me my home, he has started some housing, like fast-track housing near the United Center. So, they have moved on. It seems to be after they make so much money and then when this situation came up, everybody kind of scattered and went about their own ways, and some folks have totally disappeared.

Senator DURBIN. Cockroaches will scatter when you turn on the lights.

Let me ask you, this fellow who did the appraisal on your house, James——

Ms. ROLLINS. Koechle.

Senator DURBIN. Is that how you pronounce it? He was indicted by a Federal grand jury, as I understand.

Ms. ROLLINS. Yes.

Senator DURBIN. Do you know of anyone else who has been indicted as a result of what happened to you?

Ms. ROLLINS. No.

Senator DURBIN. Have you reported the people who were involved in your transaction to State and local agencies so that they know the experience you have been through?

Ms. ROLLINS. Yes. The State's Attorney's office, I have talked to two agents that worked for the Federal Bureau of Investigations. I have touched bases with a lot of people about this case, so it is well known in Chicago.

Senator DURBIN. Is Dependable Mortgage still in business?

Ms. ROLLINS. I have no idea. I can't say yes or no.

Senator DURBIN. Madam Chair, I would like to put into the record here a chart which is interesting. It shows the foreclosures in the Chicagoland area.[1] And these do not include FHA and VA foreclosures. In 1993, there were 94 foreclosures. In 1998, the figure is up to 3,502, not including FHA and VA. So there is a dramatic effort by these sub-prime lenders to drag people into these real estate deals that they know they can't pay off. And it isn't just young families such as those represented here today. There are a lot of senior citizens who are being victimized—your mother, of course, is in your home purchase deal, but there are senior citizens who are being victimized as well.

I would like to spend a minute, if I could, talking about what has happened as a result of this. Ms. Smith, you say you have gone to bankruptcy court. Is that correct?

Ms. SMITH. Yes.

Senator DURBIN. And the people who gave you the mortgage on your home, are they filing a claim against you in bankruptcy court?

Ms. SMITH. Yes. Now the house is in foreclosure.

Senator DURBIN. It is in foreclosure. So the company that loaned you the money for the purchase of the home is basically suing you to pay off the balance on the loan.

Ms. SMITH. Yes.

Senator DURBIN. Ms. Pratts, have they started foreclosure proceedings against you yet?

Ms. PRATTS. Not yet, but I know for a fact my house doesn't have insurance now. I just sent out an application for insurance through the Principal Residential Mortgage, and I am thinking about having a bankruptcy because I am the only one working now. My husband doesn't have a job right now.

Senator DURBIN. And you said you have been unable to keep up with the mortgage payments because of the expenses?

Ms. PRATTS. I pay my mortgage, but late. But I have to pay the interest, which is $34.

Senator DURBIN. I see.

Ms. Rollins, what is your situation? Have they filed a foreclosure action against you?

Ms. ROLLINS. Yes. I am currently in foreclosure, just waiting for basically the notices to come in the mail to tell me exactly what I need to do. I am involved with the Legal Aid Foundation. They are in litigation right now, and they are trying to get some loss mitigation going. But other than that, I am just basically waiting, but by no means will I file bankruptcy.

Senator DURBIN. You don't want to do that?

Ms. ROLLINS. No.

Senator DURBIN. Are you still living in the house?

Ms. ROLLINS. Yes.

Senator DURBIN. Well, I think it is clear, Madam Chair, from the record here what happens. It isn't just a bad deal and a tragic story. It ends up in a legal proceeding where the people who have deceived you are now going into our courts and saying the law is on their side. Isn't that amazing that the law would be on their side with all of this happening to you, all of the deception and all

[1] See Exhibit No. 6 which appears in the Appendix on page 181.

of the exploitation that has been involved in it? And to think in bankruptcy court that they are going to be standing in line and sifting through whatever assets you have left and saying we are going to take as much of this as we can. That to me is an outrage. And it is a shame that we in Congress didn't summon the will to deal with that directly.

We are going to have testimony a little later about FHA and whether they have done a good job in keeping people out of this business like the dregs of the credit and real estate industry with whom you have been involved. But thank you for your testimony today. It really has had an impact on us.

Thank you, Madam Chair.

Senator COLLINS. Thank you, Senator Durbin.

Ms. Rollins, let me follow up on what Senator Durbin was saying. Did the fact that you knew your mortgage was insured by the Federal Government give you a sense of security, of thinking, surely, if the Federal Government is standing behind the mortgage on my house, the house is going to be in good condition?

Ms. ROLLINS. Yes. That was the whole reason for me continuing with this process because the first visit with Mr. Sandow was kind of sketchy. I got kind of—some red flags went up, but after he had said it to me that HUD and FHA would work together and this was a program, a pilot program that they were starting in Chicago, I felt a little more confident about making the choice and going ahead with the process.

Senator COLLINS. See, I think that is a very logical conclusion for you to have drawn. Clearly, when you see that your loan is backed by the Federal Government, you should be able to assume that the house that you are buying is in good condition. And I agree with Senator Durbin, and as I said in my opening statement, I think HUD in some ways has been an accomplice to the problem. I think that it bears a great deal of responsibility for allowing the flipping problem to go unchecked for so long. They have taken some recent steps, but this problem has been going on for a long time.

I want to ask you about—I want to show you a form that was signed by the seller of the house that you bought.[1] Now, you have testified that you were told that the house was going to be completely rehabilitated before you moved into it, and this form—is there a copy? Could we provide a copy for Ms. Rollins? Because it is a little hard to see from here.

This is a disclosure form that the seller signed indicating that the house is basically free of major defects. For example, the form indicates that the seller was aware of no major problems in the walls or floors, no material defects in the electrical system, no material defects in the plumbing system. And you and your mother signed the form to show that you received it.

Was this form one of the reasons why you felt that the house was fine? Because here you have a signed statement from the seller certifying that it was free of these defects. Was this something you relied upon?

Ms. ROLLINS. Yes.

[1] See Exhibit No. 3.b. which appears in the Appendix on page 174.

Senator COLLINS. And based on your experience, it is obvious that the seller misled you, that he wasn't telling the truth on this form. Is that correct?

Ms. ROLLINS. Yes.

Senator COLLINS. Now, let's go through a few of the specifics. The seller stated that he wasn't aware of any problems with the walls, the floors, or the foundation. Now, I understand that you found spaces that had developed between the floors and the walls and that the foundation is crumbling. Is that accurate?

Ms. ROLLINS. Yes.

Senator COLLINS. Could you tell us more about the problems with the walls and the floors and the foundation?

Ms. ROLLINS. Basically the foundation was crumbling from the very first time that I went to look at the home. Mr. Sandow told me that it would be repaired. It has not been repaired.

The walls and the floors have never met. When I visited the home on the first occasion, like I said, it was fire-damaged. It was always like that. What they did was when they put the new dry wall in and the border around the floor, that kind of would give you the indication that it had been repaired. But over time if you take away the carpet or when you are cleaning the home, you can notice little defects.

Senator COLLINS. And, similarly, this form also says that the house's electrical system is sound, that it is free of any material defect. Did you find that to be true? Tell us about the sockets and the electrical outlets in your home.

Ms. ROLLINS. Well, the whole house, they have two separate electrical boxes for the first floor and the second floor. Those wires, even though they are housed in two separate electrical boxes, they are crossed. So if I am using a large appliance on the first floor, like, say, the washer, if you turn the microwave on on the second floor—and mind you that it has its own electrical box—it will blow the whole house.

Senator COLLINS. And it is my understanding that one of the light sockets actually shoots sparks.

Ms. ROLLINS. Yes. In the basement, we have four light fixtures. Out of the four, only two are operable because they can't—the one system will overload if all the lights are on in the basement.

Senator COLLINS. Now, the seller also claimed that the plumbing system in your house was free of material defects, and yet I understand you had a lot of plumbing problems as well. Could you tell us about those?

Ms. ROLLINS. Yes. The toilet on the first floor overflows. The toilet on the second floor overflows just by itself. It flushes by itself. The toilet on the second floor has fallen into the first-floor master bedroom on three occasions.

I had called out a company to have them go into the crawl space to look at the stack. I thought that that may be causing the water to rise, like debris was in there. The gentleman did come out to the home, and what he told me was that he could not repair the stack because there was cement in the stack and it had solidified, and he could not break it up to get into the system. So it is permanently like that.

Senator COLLINS. I want to state for the record that the Subcommittee staff attempted to interview the individual who signed this document and who sold you the home, and he asserted his Fifth Amendment rights and refused to answer any questions.[1]

Let me ask you just a couple more questions, and then we will move on to our next panel.

I would like to ask you a question about part of your mortgage application, the section depicting the monthly income and combined housing expense information.[2] Now, this shows that you receive $618 a month in rental income, and that was used to qualify you and your mother for the mortgage so that you would meet the income levels. And the reason why there are income levels is to make sure you can afford to pay for the mortgage.

Do you, in fact, receive $618 in rental income every month?

Ms. ROLLINS. No.

Senator COLLINS. Did you put that number on that form?

Ms. ROLLINS. No.

Senator COLLINS. Did you tell anyone to put that number on that form?

Ms. ROLLINS. No.

Senator COLLINS. And you weren't even aware that that number had been put on the form to make it appear that you qualified for the mortgage?

Ms. ROLLINS. No.

Senator COLLINS. Thank you. So this is an example where there was falsification or doctoring of some of your financial data to make it look like you could qualify for this mortgage. Is that an accurate statement?

Ms. ROLLINS. Yes.

Senator COLLINS. OK. I do want to thank you all for coming forward with your stories today. As I said, it is absolutely wrong what has happened to you, and I know I speak for Senator Durbin and myself, that we are absolutely committed to putting in place protections that will ensure that this does not happen to others. There clearly needs to be a crackdown on the unscrupulous real estate agents, appraisers, and lenders who are involved in this. HUD needs to do a much better job to ensure that other homeowners don't go through this.

Each of you is a first-time homebuyer, and in virtually every case of the victims we interviewed, that was the case. So the people who are being exploited are the very people that these Federal housing programs are designed to help. We are determined to put a stop to this, and I can't thank you enough for being willing to come forward and tell your stories. Thank you so much.

Ms. SMITH. You are welcome.

Ms. ROLLINS. Thank you.

Ms. PRATTS. Thank you.

Senator COLLINS. You are excused now.

Our final witness today is Stanley Czerwinski, who is the Associate Director of the General Accounting Office's Division of Resources, Community, and Economic Development. In response to a

[1] See Exhibit No. 1 which appears in the Appendix on page 115.

[2] See Exhibit No. 3.c. which appears in the Appendix on page 175.

joint request from Congressman Rick Lazio and myself, GAO conducted an investigation of the Department of Housing and Urban Development's supervision of FHA lenders. Today GAO will release its report entitled "Single-Family Housing: Stronger Oversight of FHA Lenders Could Reduce HUD's Insurance Risk." [1]

I am going to ask Mr. Czerwinski to introduce the two gentlemen who are accompanying him today, but before you get comfortable, if you will please stand so that I can swear in pursuant to Rule 6. Would you raise your right hand? Do you swear that the testimony you are about to give to the Subcommittee will be the truth, the whole truth, and nothing but the truth, so help you, God?

Mr. CZERWINSKI. I do.

Senator COLLINS. I know you are familiar with the lighting system, and so, Mr. Czerwinski, I will ask you to introduce the two gentlemen with you and proceed with your statement.

**TESTIMONY OF STANLEY J. CZERWINSKI,[2] ASSOCIATE DIRECTOR, HOUSING AND COMMUNITY DEVELOPMENT ISSUES, RESOURCES, COMMUNITY, AND ECONOMIC DEVELOPMENT DIVISION, U.S. GENERAL ACCOUNTING OFFICE, ACCOMPANIED BY ROBERT PROCACCINI, ASSISTANT DIRECTOR FOR FHA INSURANCE PROGRAMS, AND PAUL SCHMIDT, ASSISTANT DIRECTOR FOR SINGLE-FAMILY HOUSING PROGRAMS**

Mr. CZERWINSKI. Thank you, Madam Chairman. To my left is Paul Schmidt. Paul is our Assistant Director for Single-Family Housing Programs. And to my right is Bob Procaccini. Bob is our Assistant Director for FHA Insurance Programs.

Senator COLLINS. Thank you.

Mr. CZERWINSKI. Madam Chairman, I would like to thank you for holding this hearing. As you know, GAO tries very hard to put a human face on the issues that we cover, and we couldn't have done it anywhere near as well as you have just done with this past panel. The stories that you have seen illustrate the kinds of issues that we uncovered during our review. And as you know, this review was undertaken at your request, and the report was released earlier this week.[1]

Our report evaluates HUD's oversight of FHA mortgages, and is aimed at avoiding the kind of things that we saw today. HUD has three oversight components, and I would like to give a brief description of these after I talk a little bit about FHA. The three components are:

Approval of FHA lenders. Approval is designed to only let good lenders in the program.

Second is monitoring, and monitoring is designed to make sure those lenders that you let in the program do a good job.

The final step is enforcement, and that is designed to take action against those lenders that don't do a good job.

Before I go into these three steps in more detail, I would like to take a step back and talk a little bit about FHA.

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[1] See Exhibit No. 7 which appears in the Appendix on page 182.
[2] The prepared statement of Mr. Czerwinski appears in the Appendix on page 87.

FHA is the principal provider of Federal mortgage insurance. More importantly, it is the major lending source for first-time, low-income, and minority homebuyers.

For example, one-quarter to one-third of all low-income and minority homebuyers got their homes through FHA insurance, and three-quarters of FHA's portfolio is devoted to first-time homebuyers.

FHA relies on about 10,000 lenders to carry out its mission. About 2,900 of these lenders are granted what is called direct endorsement authority. That means these lenders can gather and process the information, underwrite loans, make eligibility determinations, and they do this with no prior review from HUD. The remainder of the lenders are called loan originators. Loan originators can gather such information as mortgage applications, employment verification, credit histories, but then they must go to one of the 2,900 approved lenders for underwriting and eligibility determinations.

Given HUD's reliance on private lenders, oversight is essential. Such oversight is the primary responsibility of four homeownership centers that HUD has in Atlanta, Denver, Philadelphia, and Santa Ana. Our team visited all four homeownership centers, and we found problems in the three areas I just mentioned: Approval, monitoring, and enforcement.

The major problem with approval is consistency. When lenders apply for FHA approval, they go through a probationary period. During that period, FHA evaluates their performance. HUD guidance requires that lenders must have "acceptable" performance to be approved, but the guidance does not specify what acceptable is. Given such general criteria, it is not surprising that the four centers we visited apply the standards differently.

For example, during our review, 36 lenders applied for FHA approval. Some of these lenders had no significant problems at all during their probationary period; however, others had as much as 40 percent of the loans they made while on probation with serious problems. All 36 lenders, those with no significant problems and those with up to 40 percent, were approved because their performance was deemed acceptable.

Once lenders are in the program, the key then becomes to monitor their performance. HUD monitors their performance in two ways: It conducts on-site reviews of lenders' operations; it also has desk reviews of the paperwork associated with each loan. HUD guidance requires that both of these types of reviews be targeted to high-risk lenders and loans. However, we found that HUD did not target reviews to these high-risk lenders and loans.

For example, of the four homeownership centers, only Philadelphia developed a list of high-risk lenders to prioritize the reviews, and even in Philadelphia, they only covered about 20 percent of the number of high-risk loans that they were supposed to cover.

As I mentioned, enforcement is the third step of the oversight process, and enforcement has essentially three components: The first is the homeownership centers may suspend lenders for poor performance; the second is lenders may be referred to HUD's Mortgagee Review Board for such actions as indemnification, termination, or fines and penalties; the final step of the enforcement process is Credit Watch, and I would like to spend a moment or two on Credit Watch because it really is the crown jewel of HUD's attempts to enforce its actions.

Credit Watch works according to automatic sanctions that are applied to lenders based on their default rates and claim rates. However, we found two problems with Credit Watch.

First of all, Credit Watch only holds accountable those lenders who originate loans. When the same lender originates and underwrites a loan, this isn't a problem. However, when one lender originates a loan and then must go to an underwriter, in that case the underwriter gets a free ride under Credit Watch.

The second problem is that lenders have successfully challenged in court HUD's authority to impose Credit Watch. Yesterday Senator Sarbanes and Senator Mikulski said they were introducing legislation that would remedy this problem.

We support clarifying HUD's authority regarding Credit Watch. We also recommend that Credit Watch be extended to all lenders within FHA. Our report also contains a number of recommendations aimed at improving the approval, the monitoring, and the enforcement functions that HUD has. I am happy to say that HUD agrees with the recommendations we are making, and they have told us that they promise to take action. I know HUD will be up here tomorrow, so you can follow up on that, I am sure.

That concludes my statement. I am glad to answer any questions that you or Senator Durbin may have.

Senator COLLINS. Thank you, Mr. Czerwinski. I thought your report was very well done, and I appreciated the efforts that GAO has made in this regard.

Your testimony, as well as the report that was dated April and released earlier this week, outlines a number of weaknesses in HUD's system for lender approval, monitoring, and enforcement that pose risks for the first-time homebuyers that we have heard from today and also for the insurance fund. But this wasn't the first government report to cite problems. It is my understanding GAO has done previous reports, and the Office of Inspector General at HUD has repeatedly issued audits and reports indicating that these programs were at significant risk for fraud.

For example, way back in 1993, 7 years ago, HUD's Office of Inspector General completed an audit of FHA's single-family program and found that HUD's post-endorsement reviews did not consistently ensure quality underwriting. Based on your more recent work, is this still a problem?

Mr. CZERWINSKI. That is absolutely correct.

Senator COLLINS. In addition, back in 1993, the Office of Inspector General found that HUD was not effectively using sanctions to protect the integrity of the program. Sounds like you found the same thing.

Mr. CZERWINSKI. Yes, Madam Chair.

Senator COLLINS. The same report back in 1993 found that the direct endorsement underwriter approval process was not effective. That is again what we heard today, is it not?

Mr. CZERWINSKI. That is exactly right.

Senator COLLINS. So it appears that the IG identified essentially the same kind of problems that you found in your review 7 years ago.

Mr. CZERWINSKI. That is correct.

Senator COLLINS. And it wasn't just back in 1993. It isn't as if there was a report in 1993 and nothing happened for 7 years. It is my understanding that GAO did some work in 1997 that looked at the appraisal process, and we have heard a lot about faulty appraisals today. Could you tell us a little bit about the report done in 1997?

Mr. CZERWINSKI. Yes, Madam Chair. When you look at the lending process, the two key players are lenders and appraisers. And the one thing that they have in common is that in both cases HUD has to rely on these agents to carry out the program. In both cases, the agent sometimes may have different incentives than HUD, or the American taxpayer, or the borrower, and that is why oversight is very important. In both cases, because you want to put in incentives to make those agents behave along the same lines that you would like them to.

So, just like our report on lender oversight, which talks about approving, monitoring, and enforcing, the same issues of approving appraisers, making sure the appraisers do a good job, and then taking action is valid also.

Senator COLLINS. And then in 1999, it is my understanding, 2 years later, GAO issued yet another report entitled "Single-Family Housing: Weaknesses in HUD's Oversight of the FHA Appraisal Process." And I want to read some of the findings.

GAO found that HUD is not doing a good job monitoring the performance of appraisers; HUD is not holding appraisers accountable for the quality of their appraisals; HUD has limited assurances that the appraisers on its roster are knowledgeable.

Is that an accurate summary?

Mr. CZERWINSKI. Absolutely, Senator.

Senator COLLINS. So, once again, we see a pattern of reports and audits over a 7-year period, time and time again, making the exact same criticisms of HUD's programs. Is that accurate?

Mr. CZERWINSKI. Yes, Senator, and it points out the importance of approving, monitoring, and enforcing what you want your agents to be doing.

Senator COLLINS. I would now like to go to your most recent report and ask you a few questions to highlight some of the findings. Now, it is my understanding that FHA relies almost exclusively on direct endorsement lenders to underwrite the mortgages that it ensures. Is that accurate?

Mr. CZERWINSKI. That is correct.

Senator COLLINS. And you talked about that HUD has inconsistent standards for approval of lenders who apply for direct endorsement authority. And as a result, some lenders with very questionable proficiency were approved. In fact, you said that even lenders who were found to have 40 percent of their mortgages they submitted had problems with them, some of them rated poor, received approval nonetheless. Is that right?

Mr. CZERWINSKI. That is correct.

Senator COLLINS. So nobody was turned down?

Mr. CZERWINSKI. Not during the period of our review.

Senator COLLINS. That you looked at.

Mr. CZERWINSKI. We looked at 36. All 36 were approved.

Senator COLLINS. All 36 were approved despite the fact that there were significant deficiencies in the mortgages that were submitted for review by some of the lenders.

Mr. CZERWINSKI. That is correct.

Senator COLLINS. It sounds like a pretty automatic system to me, if you can still get approved when you have significant deficiencies.

Could you provide us with an example of a direct endorsement lender that HUD approved with questionable proficiency?

Mr. CZERWINSKI. Well, I think the key issue, first of all, is that the standards are very general, and, therefore, the application of the standards can lead to inconsistency. As the chart to your left shows, for the four offices that we went to, the number of problems that were encountered by the lenders applying for approval. As you can see, it is all over the board; that is inconsistent.[1]

Senator COLLINS. Now, I want to make sure again that I understand that process. It is my understanding that when HUD looks at the mortgages that are submitted as part of an application for direct endorsement authority, they rate the quality and that there is a classification of, what, good, fair, and poor. Is that correct?

Mr. CZERWINSKI. That is absolutely right.

Senator COLLINS. And you looked at 36 of those. Did you find that HUD actually granted direct endorsement authority to 12 lenders who had earned, if that is the right word, a rating of poor?

Mr. CZERWINSKI. On some of their loans, yes.

Senator COLLINS. On some of the loans that were submitted. And were these errors significant errors? In order to get a poor rating, can you give us an idea of the kinds of errors that would be made?

Mr. CZERWINSKI. Yes, they were significant errors.

Mr. SCHMIDT. I can probably do the best job giving you examples of that.

Senator COLLINS. That would be helpful, Mr. Schmidt.

Mr. SCHMIDT. What we found—and this kind of probably goes across the three that had the 40 percent of their loans in poor condition—was a failure to verify income and employment——

Senator COLLINS. A pretty basic requirement.

Mr. SCHMIDT. Pretty basic requirement. Failure to ensure that the borrower had enough income to make the payments.

Senator COLLINS. Critical, and we have heard what happens when the homeowner can't afford it.

Mr. SCHMIDT. Failure to explain delinquencies on credit card debt or a collection on credit card debt, and also failure to properly calculate the debts and liabilities the borrower had, which are all fairly basic types of issues.

Senator COLLINS. So these lenders which showed that they did not have the capacity to underwrite these mortgages correctly were approved nevertheless. That is accurate?

Mr. SCHMIDT. Correct.

Senator COLLINS. And your review of these cases was just last year. Is that correct?

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[1] See Exhibit No. 8 which appears in the Appendix on page 227.

Mr. SCHMIDT. Correct.

Senator COLLINS. So this isn't ancient history. Mr. Czerwinski, you mentioned that of the four HUD centers that you looked at, only the Philadelphia center suspended the direct endorsement authority of any lenders during the period that you looked at, during 1999. Yet I believe it is accurate to say that you identified more than 200 lenders nationwide that had poor ratings as a result of the monitoring that HUD is doing. Could you talk about that issue?

Mr. CZERWINSKI. That is exactly correct, Senator. When a lender is suspended, the homeownership center then has to go through the process of reviewing every single loan that that lender makes as a lender tries to get its position reinstated. That is a large workload effort for the staff at each of the homeownership centers.

Senator COLLINS. So it is part of the dynamic here that if a homeownership center suspends the lender, takes away the direct lending authority, they are going to have to do the work?

Mr. CZERWINSKI. That is correct.

Senator COLLINS. And that discourages them from pulling back the authority?

Mr. CZERWINSKI. We talked to the staff at the centers, and they said that the workload was certainly a factor that they considered.

Senator COLLINS. Of those 200 lenders that you identified, how many of them were actively writing FHA mortgages? I am talking about the lenders that received the poor ratings as a result of the reviews.

Mr. CZERWINSKI. All of them were.

Senator COLLINS. Senator Durbin.

Senator DURBIN. Thank you very much. We are going to have testimony, are we not, Madam Chair, from Secretary Cuomo tomorrow?

Senator COLLINS. He has declined our invitation to come and instead is sending a deputy, Mr. Apgar.

Senator DURBIN. To speak on behalf of FHA?

Senator COLLINS. On behalf of the Department.

Senator DURBIN. In the course of the investigation here, did you hear from HUD that there was any budgetary reason driving this lack of scrutiny and surveillance?

Mr. CZERWINSKI. The way we do our work: We go out and find what the agency is doing; then we go back to the agency and verify what we found; we ask them why they think some of these things are happening. One of the reasons that we were given by homeownership center staff was resources, in terms of travel to go out and visit lenders—to do the inspections.

Senator DURBIN. Did you follow through on that? Was that something that made sense?

Mr. CZERWINSKI. It makes sense.

Senator DURBIN. But did they not change the configuration of the groups that were reviewing lenders to these regional centers from, I guess, 10 or 12 offices to four regional centers?

Mr. CZERWINSKI. That is exactly right.

Senator DURBIN. And what year did that happen?

Mr. CZERWINSKI. That happened in 1997 or 1998.

Senator DURBIN. Did you take a look at the HUD efforts before and after this regional service center approach to compare their activities?

Mr. CZERWINSKI. Some of our earlier work looked at HUD prior to the reorganization, so we did have that type of comparison.

In terms of the reorganization that created the four homeownership centers, I think it is a good news/bad news answer. The good news is that HUD is putting more resources in terms of staff for overseeing lenders—their allocations are higher. The bad news is that many of these staff haven't been doing this work before, so that one of the reasons HUD told us why they hadn't targeted as many of the high-risk lenders is that they felt their staff hadn't gotten up to speed enough to deal with these more difficult cases.

Senator DURBIN. I also read somewhere that the number of employees involved in this review and surveillance, when HUD went to the regional centers, was cut substantially. Is that true?

Mr. CZERWINSKI. The overall number of employees that HUD has put into the homeownership centers has been reduced. However, HUD has put in more resources to look at lenders. The number of lender reviews is up.

HUD does their reviews in two ways: One, they have HUD staff do them; and the second is that they rely on contractors.

Senator DURBIN. I want to make sure the record is clear. Before the reorganization, before the creation of the regional service centers, if you compared the number of FTEs or employees involved in surveillance of these lenders before and after, can you tell me the comparable numbers that were involved?

Mr. CZERWINSKI. We don't have the precise overall numbers. I can provide those for the record if you would like.

Senator DURBIN. I read somewhere, and I can't find it as I sit here, but I read somewhere that the number of employees involved in surveillance or review was cut in half when they went into this reorganization. Does that sound right to you?

Mr. CZERWINSKI. Yes. There are a number of aspects of surveillance, not just monitoring of FHA 203(b) lenders, and I think that you are picking up that overall number. Mr. Apgar, who is the FHA Commissioner, is going to be here tomorrow, and he should be able to give you the precise overall numbers. I can also get them for the record.

Senator DURBIN. I wonder—and we will find out tomorrow—how much of this was driven by congressional appropriations and how much was driven by a HUD decision. If HUD decided to step back from its responsibility, then, of course, they have some hard questions to answer. Do you know whether or not there was congressional input into this reorganization?

Mr. CZERWINSKI. We have looked at HUD's reorganization. It is called their "20/20 Reform Plan." In many respects, the reorganization is the Secretary's response to his analysis of what the Department needed to do. Obviously one factor in the input would be what reviews were conducted by us and what kind of oversight was conducted by the Congress and others.

I don't recall anybody saying that we should give less scrutiny to oversight of lenders such as FHA, and as a matter of fact, GAO is on the record of talking about more needs in that area.

Senator DURBIN. I see in your report here that you noted that HUD's single-family housing staff was cut by more than 50 percent under the 20/20 plan.

Mr. CZERWINSKI. Yes. That is the overall staffing.

Senator DURBIN. Well, I think that will be an interesting thing. Of course, if this is HUD's decision that they don't need review and surveillance, that is one thing. If Congress said we won't give you the money for review and surveillance, then it kind of creates another challenge for us to look and see where responsibility might lie.

And then do I take it from your testimony that since there have been abuses, HUD has now responded with more people involved in this?

Mr. CZERWINSKI. HUD has said that they agree with our findings and recommendations and has talked about planned initiatives. We haven't seen any resource allocations according to how that would be done.

Senator DURBIN. One of the groups or companies, rather, that was involved in the earlier testimony, this Easy Life, if I remember correctly had been found guilty of prior wrongdoing, and they still continued on the FHA approved list.

Address that for a moment, if you will. Do you think HUD met its responsibility when a lender that has been involved or a realtor that has been involved in wrongdoing, paid a fine, for example, for this wrongdoing, and continues its wrongful practices? Were you able to address that in your investigation?

Mr. CZERWINSKI. We did not specifically look at Easy Life. But, obviously we found some gaps in the system in which lenders are approved, monitored, and then enforcement action is taken.

Senator DURBIN. Now, one of the things that we have found in this Subcommittee when Chairman Collins has called previous hearings is that once you nail down a wrongdoer, they have a tendency to disappear and reappear in a different form with a different name—the same people, the same problems, coming at it with a new application.

Have you found evidence of that in this particular problem?

Mr. CZERWINSKI. We did not look at that particular aspect, but I would go back to the point that I was making about approval, because that really becomes an approval issue. If the lender comes back in a different incarnation, the question is: What criteria are used to reapprove or approve that lender? And then how are those criteria applied?

The point that I was making is that the approval process has very general criteria which allows for inconsistencies.

Senator DURBIN. One of the questions that I asked during the brief break before your panel was started was of an attorney from Chicago who is representing some 200 homebuyers who were victimized by this Easy Life operation. And I asked her: Well, what response have you received from the Illinois Association of Realtors in terms of these folks that have been involved in this? And I don't want to put words in her mouth, but she wasn't very encouraging. They haven't really received any kind of response.

Did you monitor any efforts beyond HUD and FHA by professional organizations, whether it is a realtors' organization or the banking industry in a given State or locality, to take action against those who have been found guilty of wrongdoing through this program?

Mr. CZERWINSKI. That was not a course that we followed. What we did do, however, was to look at others who are in similar roles to HUD, specifically the GSEs. We asked how they did their oversight, and then had that as a comparison.

Senator DURBIN. And tell me what you found to be best practices in this area. What did you find that we could use as an example to clean up this situation?

Mr. CZERWINSKI. We saw a difference in terms of monitoring, and HUD in that case has the right idea about targeting high-risk lenders. However, in terms of implementation, we found the other parties to be further along than HUD in terms of how they went about targeting. That was probably the major point; that if we could get HUD to improve its risk-based analysis, that would help.

Senator DURBIN. And that improvement, would it involve more technology, more personnel, both? Tell me what you mean by that.

Mr. CZERWINSKI. I think probably the major place that HUD could make an improvement in this area is in the information that it has and the way that it uses it. HUD's data systems currently are not quite so facile at identifying the risk factors. If the information systems could readily pop out the risk factors such as defaults, volume, when the last reviews were undertaken, this would help target the monitoring better.

Senator DURBIN. I am going to close at this point. I think that Senator Collins made a good point with one of our earlier witnesses. When they hear "government-insured," it gives them great peace of mind that this great government of theirs is going to stand behind them, and then they find out by bitter experience that it isn't worth much. In fact, they have been misled not only by the people on the street, the realtors and the lenders, but they have been misled by this label that suggests some approval of a process that, frankly, never should have been approved. That falls back on our shoulders. Those of us in government have a responsibility to make sure we do our part of the job. It isn't just a "buyer beware" culture. And these new homebuyers, with the dream of doing something that most of us look forward to and appreciate as a great moment in our lives, deserve better. They deserve better from HUD, from Congress, and I hope that this hearing will lead us to follow some of your recommendations. Thank you for your investigation.

Thanks, Madam Chair.

Senator COLLINS. Thank you, Senator Durbin. Mr. Czerwinski, just a couple more questions. Isn't a major part of the problem that HUD's approval system is so flawed that mortgage companies with poor records are getting certified in the first place? Isn't that a likely predictor of problems down the road, if they are making the kinds of basic mistakes that Mr. Schmidt described, aren't they likely to end up as high-risk lenders that are going to create the kinds of problems we have explored this morning?

Mr. CZERWINSKI. I think you are absolutely right. When we talk about oversight, probably the most important part of oversight is stopping the problems before they come in the door.

Senator COLLINS. Exactly. We have got to stop these lenders from being certified in the first place, and it is inconceivable to me that HUD is certifying lenders that don't pass their own test, that submit applications that are so flawed that HUD itself rates them as poor and then turns around and gives them direct endorsement authority. I just am at a loss to understand why that is happening.

Mr. CZERWINSKI. The answer is that the criteria for what is an acceptable application are so vague that it leaves it open to interpretation. So the key in our minds would be to specify exactly what HUD means by "acceptable" in terms of the number of loans that have significant or serious problems.

Senator COLLINS. But HUD is deeming acceptable and, thus, giving direct endorsement authority to lenders that HUD itself rated as poor. Is that correct?

Mr. CZERWINSKI. That is correct.

Senator COLLINS. That just is inconceivable to me.

The final question I want to ask you, Mr. Czerwinski, is to respond to a point that Mr. Apgar, who will be testifying before us tomorrow, made about the economic value of the insurance fund. In your report, you gave HUD, appropriately, a chance to respond to your criticism, and Mr. Apgar pointed out that the economic value of the fund stands at an all-time record high.

Could you tell us why that may be, whether it is really due to HUD's actions or is it due to other factors? And could you also comment on the impact of the dramatic increase in the number of HUD properties that have been foreclosed upon on the value of the fund?

Mr. CZERWINSKI. Sure. There are probably three factors that drive the value of the fund, and I would probably put them in this order: The first is the overall economy. The economy is very strong. This has driven housing prices up, interest rates down. That has helped FHA immensely.

The second are changes structurally that the Congress has made to FHA in terms of the premiums. Back about 10 years ago, FHA's picture was not anywhere near as rosy as it is today, and the Congress, working with HUD, decided that it had to raise insurance premiums. Those premiums have been raised. More money has been coming into the fund.

The third part is HUD's management of the fund.

Those are the three factors. I would put them in that order.

Mr. PROCACCINI. If I could add to Mr. Czerwinski's answer, Madam Chair?

Senator COLLINS. Yes.

Mr. PROCACCINI. To give an example of the impact of the economy on this fund, one needs to just look at the latest actuarial study report, and in that report it talks about what would happen if the fund—if economic conditions that prevailed over the next 30 years were less optimistic, less positive than what was deemed to be the baseline case this year, and by using lower economic predictors, the fund, it was estimated by Deloitte Touche to be worth about $12.3 billion. So that is about 26 percent less than their baseline case. So that is about $4.3 billion less the fund would be worth if these economic conditions were not as optimistic. So that gives you a demonstration of the economic impact of the economy on the reserves of this fund.

Senator COLLINS. That is a very important point. So I think what you are telling me is that it has been the combination of economic prosperity plus the increase in premiums assessed to the homebuyers that has been responsible, that have combined to increase the value of the fund and helped to offset the increase in foreclosures. Is that an accurate statement?

Mr. CZERWINSKI. Those are major factors.

Senator COLLINS. And it is important for us to keep in mind that if the premiums have to be increased in order to offset—keep the fund healthy and in order to offset the cost of foreclosures, that that cost is being passed right back to the homebuyers. Is that accurate?

Mr. CZERWINSKI. That is correct, and the homebuyers are typically low-income, minority, first-time homebuyers who are bearing this cost.

Senator COLLINS. Thank you very much for your testimony. It has been very helpful. I again want to commend you for the thoroughness and the high quality of your report. It is always a pleasure to work with GAO, and we very much appreciate your contributions in this area.

Thank you very much.

Mr. CZERWINSKI. Thank you, Madam Chair.

Senator COLLINS. Before we recess today, I want to just once again thank all of our witnesses, but particularly the three women who testified so eloquently about their experiences. We very much appreciate your coming forward. I know it was a very difficult thing to do, but you added immensely by putting the human face on this problem. We do talk about statistics all day long here, but when we hear the personal stories of people affected by fraudulent schemes like this, that is when it really hits home. So I want to thank all of our witnesses today.

We will resume the hearing tomorrow. Based on the testimony we have heard today, I am convinced that flipping is an extremely serious and growing national problem and that we need to take much tougher action. I am also convinced that HUD has not done an effective job in overseeing the lenders and the other players involved as it stands behind these mortgages with the insurance fund.

I look forward to hearing HUD's explanation tomorrow and to questioning HUD's Assistant Secretary for Housing, as well as the inspector general for HUD.

With that, this Subcommittee will stand in recess until tomorrow morning at 9:30. Thank you very much.

[Whereupon, at 12:08 p.m., the Subcommittee was adjourned.]

# HUD'S GOVERNMENT INSURED MORTGAGES: THE PROBLEM OF PROPERTY "FLIPPING"

**FRIDAY, JUNE 30, 2000**

U.S. SENATE,
PERMANENT SUBCOMMITTEE ON INVESTIGATIONS,
OF THE COMMITTEE ON GOVERNMENTAL AFFAIRS,
*Washington, DC.*

The Subcommittee met, pursuant to notice, at 11:05 a.m., in room SD–342, Dirksen Senate Office Building, Hon. Susan M. Collins presiding.

Present: Senators Collins and Durbin.

Staff Present: K. Lee Blalack, II, Chief Counsel and Staff Director; Mary D. Robertson, Chief Clerk; Rena M. Johnson, Deputy Chief Counsel; Karina Lynch, Counsel; Brian Jones, Investigator; Claire Barnard, Detailee/HHS–IG; Jim Pittrizzi, Detailee/GAO; Raymond Kessenich, Detailee/NCIS; Bob Groves, Detailee/HUD–OIG; Elizabeth Hays, Executive Assistant; Adam Thomas, Intern; Christopher Kramer, Intern; Steve Abbott (Senator Collins); Marianne Upton and Jessica Porras (Senator Durbin); and Glen Sauer (Senator Akaka).

## OPENING STATEMENT OF SENATOR COLLINS

Senator COLLINS. The Subcommittee will come to order. I first want to apologize to our witnesses this morning and to others, who are here today for the hearing, for the delay in convening. We had an additional two votes that I was not counting on when we changed the time of the hearing last night. So I apologize for any inconvenience that the late start may have caused.

This morning the Permanent Subcommittee on Investigations continues its examination of property flipping. As we learned at our hearing yesterday, flipping is a growing type of mortgage fraud that has devastated families and neighborhoods across this Nation. In a typical flipping transaction, a con artist purchases a rundown house in a low-income neighborhood. The seller then makes minor cosmetic repairs to the property and then attempts to unload the house on an unsuspecting buyer at a grossly inflated price. These properties are usually resold at tremendous markups, often 100 percent or more within a few months or even days.

Flippers usually target first time, low-income home buyers who are eager to own their own home and are willing to trust sellers who promise them the American dream of homeownership. Our investigation found that these unsophisticated buyers are generally unfamiliar with real estate transactions. They are essentially at the mercy of unscrupulous sellers who are often aided and abetted by unethical appraisers and lenders.

Once they have hooked the unsuspecting buyers, the sellers make arrangements to secure an FHA-backed mortgage loan to finance the transaction. In some cases, if a buyer's credit history or financial condition would scuttle the deal, fraudulent mortgage applications and phony gift letters are crafted to grease the transaction. The combination of inflated property prices, expensive repairs, and adjustable rate mortgages often leave the buyers with mortgage payments and other costs that they simply cannot afford.

Contrary to the explicit assurances of the sellers, the properties are frequently in such poor condition that the buyers must sink even more money into their homes just to render them habitable. The result is sadly predictable. The sellers escape with obscene profits and the buyers default on their mortgages. The ultimate result is often foreclosures that leave the owners with no home, tarnished credit ratings, and broken promises.

Yesterday we heard truly heart wrenching testimony from three first-time home buyers who are victims of flipping schemes. They told tragic stories of high hopes that were dashed by unscrupulous sellers, appraisers, and real estate agents, all of whom were part of intricate scams to sell them dilapidated, overvalued houses.

Our witnesses showed the Subcommittee pictures of what they had hoped would be their dream homes, but which instead proved to be houses that were crumbling and unsafe. We saw raw sewage backed up through a toilet onto the bathroom floor, severe termite infestation, rotting wood exteriors through which rats entered a roof that almost completely detached from the rest of the house, dangerous structural damage and faulty electrical systems that repeatedly burned out, placing the occupants at risk of a fire.

The ultimate tragedy is that our witnesses paid these exorbitant prices for these atrocious homes and are now saddled with mortgages and repairs that they cannot afford. In several cases, we found that flipping victims have had no choice but to default and file for bankruptcy. I am outraged that these hardworking Americans, such as those whom we heard from yesterday, have become targets of con men disguised as legitimate business people.

I am particularly disturbed, however, to learn that all of the fraudulent loans examined during Subcommittee's 9-month investigation were insured by the Federal Government. Consequently, after the crooks walked away with handsome profits, the Federal Government was left to pick up the tab for the fraudulent loans. I look forward to exploring these issues further with our witnesses this morning.

Our first witness this morning is William Apgar, who is the Assistant Secretary for Housing at the Department of Housing and Urban Development. Mr. Apgar also serves as the Federal Housing Commissioner and directs the Federal Housing Administration, reporting directly to HUD Secretary Andrew Cuomo. I look forward to hearing Mr. Apgar's testimony this morning in light of the disturbing testimony that we heard yesterday.

Pursuant to Rule 6, all witnesses who testify before the Subcommittee are required to be sworn. So I would ask Mr. Apgar to stand and raise his right hand.

Do you swear that the testimony you are about to give will be the truth, the whole truth, and nothing but the truth, so help you, God?

Mr. APGAR. I do.

Senator COLLINS. Mr. Apgar, you can proceed with your testimony. We do have a lighting system, which I know you are familiar with. We would ask you to take about 10 minutes for your oral remarks, and we will put your prepared testimony fully in the record.

## TESTIMONY OF WILLIAM C. APGAR,[1] ASSISTANT SECRETARY FOR HOUSING AND FEDERAL HOUSING COMMISSIONER, U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

Mr. APGAR. Thank you. Good morning, Chairman Collins.

Today's hearing focuses on abusive practices aimed at FHA borrowers. I understand yesterday that you heard testimony from several fraud victims.I share the Subcommittee's concern about mortgage fraud of any type, be it in the FHA or in the larger mortgage industry.

This is my top priority at the FHA. That is why I invited one of yesterday's witnesses, Mrs. Rollins, to come to my office so I could personally thank her for the courage she displayed in coming forth and sharing her story with the Subcommittee. She was accompanied by her lawyer, Nina Vinik, a woman who has worked to seek justice for those families victimized in Chicago by the Easy Life Real Estate scam.

HUD has been involved in Easy Life case for more than 5 years. In 1996, we referred Easy Life to our inspector general for criminal violations. Again, in 1996, we debarred two Easy Life Real Estate agents. We also declared a moratorium on Easy Life foreclosures in 1998 to give victims a chance to get back on their feet.

But as Ms. Rollins story suggests, there is much more we can and must do. Let me tell you what I told Ms. Rollins that day in my office. HUD is committed to ridding FHA of the problem and to help victims of mortgage scams recover. Over the last 3 years, the FHA has initiated a comprehensive approach to protect FHA borrowers from predatory lending practice and hold its private sector partners accountable for their actions.

After more than a year of development, last year in May 1999, we launched Credit Watch, a new performance-based lender monitoring and enforcement system. In the first year of operation, the FHA has terminated 48 lenders, proposed termination of another 10, and placed approximately 135 lenders on probationary lending status.

We have enhanced lender monitoring activities. Over the past 3 years, FHA has increased its lender monitoring staff more than 7-fold and increased the number of lender monitoring reviews from 256 in 1997 to more than 900 in 1999.

We have stepped up lender enforcement activities. I would like to submit for the record the enforcement actions taken in just three States, the home States of yesterday's victims.[2] These report hundred of actions we have taken in the last 15 months alone against

[1] The prepared statement of Mr. Apgar appears in the Appendix on page 97.
[2] See Exhibit No. 15 which appears in the Appendix on page 296.

real estate agents, against lenders, against appraisers who are preying on victims in these communities.

Senator COLLINS. It will be presented in the record.

Mr. APGAR. Thank you. We have also, over the past 3 years, substantially enhanced our appraisal monitoring activities. Under the Home Buyer Protection Plan announced in 1998, FHA has put in place the most comprehensive and thorough appraisal process in the market today. This initiative is now providing consumers with an unprecedented amount of information about the physical conditions of the homes they are purchasing.

In addition, we have created a more effective framework to hold appraisers accountable for the work. This new approach includes mandatory appraiser testing. This was launched in July 1999. We also now require a more thorough valuation condition report. FHA is the only mortgage finance organization in the country that requires every appraisal to include completion of a four-page form that encompasses comprehensive information regarding the physical condition of the property. Again, this has been in place now since September.

Along with the Home Buyer Protection Plan—we provide home buyers easy-to-understand information about the important issues in their appraisal so that folks will not be so readily duped in believing the home is in good repair when it is not. FHA is also requiring lenders to provide every borrower the summary condition form, and, again, it highlights many of the physical conditions that do not meet FHA minimum property standards.

We also developed and are using statistical indicators to target poor performing appraisers for extra monitoring activity. As part of this initiative, FHA also issued new regulations to clarify existing authority to pursue enforcement sanctioning against fraudulent and poor performing appraisers. This system is working. Just last month, we sent out letters to over 40 appraisers notifying them that they were about to be terminated or otherwise sanctioned in the FHA programs.

And, finally, in 1996, Congress authorized and HUD quickly moved to implement a comprehensive new program of foreclosure avoidance and loss mitigation. After assisting just 5,000 families in the first year, FHA helped 10,000 borrowers in 1998 avoid foreclosure, and in 1999, the number flew to 27,000. This year, we project 32,000 families will avoid foreclosure because of the new loss mitigation tools that are now in effect.

So we have taken serious measures to combat fraud in our programs and to help families arm themselves with the information they need to help protect them from abusive practices, but clearly the job is not done. One victim is one victim too many. That is why we are so pleased to join forces with Senator Mikulski and Senator Sarbanes and others to form the Baltimore and the national task force on predatory lenders. You heard Senator Mikulski yesterday describe these efforts.

Let me just highlight a few initiatives. The core of the Baltimore plan is a series of initiatives to provide relief to those FHA borrowers already in distress, especially those who have been victimized by predatory lending. Specific initiatives include expanded efforts to counsel borrows in default. Again, FHA relies heavily on its own network of HUD-funded counseling agencies, but there is often not enough. We have expanded the counseling effort to put of special focus on pre-foreclosure counseling.

In addition, HUD will move aggressively to force lenders to restructure inflated mortgages, that result from fraudulent appraisals or the so-called property flips. We will push the loan back to the lender and make him responsible for producing a loan that the borrower can afford. If not, the FHA will intervene directly and make the loan right for the borrower.

In addition, we are working with local governments and community groups to intensity our enforcement efforts in hot zones, areas of high default and foreclosure rates. This focus on hot zones makes sense. The highest share of FHA foreclosures occur in these hot zones. Overall each year, FHA takes back through foreclosures only about 1 percent of all loans. We have 6.7 million loans of the books. This year, we project our foreclosures will amount to approximately 67,000 or 1 percent. The number has not changed much over the past 10 years, this 1 percent figure, and today, indeed, the overall foreclosure rate is dropping.

But there will always be someone who will try to scam the system. The private mortgage industry today spends millions of dollars to rout out fraud, as do we, and we are committed to ending abusive practices wherever they occur, and we need your help, Senator Collins. As Senator Mikulski noted, we urge you and your colleagues to support legislative propositions presented in the HUD Treasury Task Force report and in the Baltimore task force report.

As you know, the HUD Treasury report calls for comprehensive assault on predatory practice with particular focus on growing abuses in the sub-prime market. These recommendations closely parallel the legislative proposals already introduced by Senators Sarbanes and Schumer here in the Senate and Representatives La Falce and Schakowski in the House. Congress should work to resolve the remaining differences amongst these various proposals and enact comprehensive legislation to reform lending practices this year.

We would also urge you to support legislation to protect the Credit Watch program from legal challenge. As Senator Sarbanes noted when he introduced this legislation, he believes, as HUD does, that we already have the authority to run Credit Watch, but rather than wait for the courts to rule, Congress has the opportunity to clarify and enhance the authority so that this important initiative will continued to be used to protect FHA borrowers from abusive lenders.

In conclusion, under the leadership of Secretary Andrew Cuomo, HUD has a demonstrated track record of routing out waste, fraud, and abuse. Predatory lending is a serious problem, and HUD has taken serious actions to hold our business partners to high standards of performance. There will always be some who attempt to defraud FHA and the millions of families who rely on FHA to purchase their first homes.

For more than 3 years, FHA has aggressively expanded its fraud protection tool kit. The results are evident. FHA is in the strongest financial shape it has ever been and well positioned to meet the future home buying needs of the Nation's low and moderate income families. I look forward to answering any questions you may have about my testimony. Thank you.

Senator COLLINS. Thank you, Mr. Apgar. I have listened very closely to your testimony, and I read your full statement when we received it late last night, and I believe that Credit Watch and the fraud protection plan that you have described are potentially very positive innovations.

I am also pleased to hear that you reached out to Stekeena Rollins, who testified before us yesterday. I would encourage you to do so with our other witnesses, and we would be happy to provide you with the names and addresses of the many other victims that we interviewed nationwide as part of this investigation.

But I have to tell you that when I read your press comments earlier this week, I have to question whether HUD really understands how serious and widespread a problem this is and whether HUD is truly committed to solving it. For example, it sounds to me like you are continuing to deny the extent of the problem when I read in an *Associated Press* story that: "William Apgar, HUD Assistant Secretary for Housing, said instances of flipping involving government-insured mortgages are isolated; we have isolated examples of fraud."

Well, the evidence is overwhelming that flipping is not an isolated problem. It is a problem in cities all over the country. The Department's Inspector General, who will be testifying later this morning, says in her testimony that massive property schemes involving FHA-insured mortgages continue to be uncovered in New York, Baltimore, Chicago, and Los Angeles. In just one case, the IG is investigating, more than 1,200 FHA-insured loans totaling over $160 million are under investigation.

Similarly, you quoted Maryland Senator Barbara Mikulski, and I share your very high opinion of Senator Mikulski and have worked closely with her on this and many other issues. She testified yesterday that there were countless properties in Baltimore alone that were flipped within 120 days, and she described FHA as an accomplice to flippers and predatory lenders.

The Subcommittee's own investigation, likewise, found significant evidence of flipping in every single city where we looked and did an investigation. We had no trouble finding scores of victims in every single city that we went to. Even Secretary Cuomo has said that this is a growing problem, and that is why the nationwide task force was convened.

So in the face of this overwhelming evidence, why are you continuing to maintain that this is just an isolated problem that pops up here and there?

Mr. APGAR. OK. Let me start with the Secretary Cuomo comment. His comments referred to the growing and obviously substantial abusive practices in the Nation's sub-prime market, the non-government portion. That is the largest share of the abusive practices that our task force has uncovered; and in Baltimore, for example, over half of the foreclosures and an equally large share of any flipping activity were outside of FHA or government-backed entirely or where our detail data suggests that we are a smaller part of that problem. Important? Yes. Significant? Yes. But his comments relate to the national task force work almost exclusively on sub-prime activity.

In terms of the statement about isolated, I understand what you are saying in what we call hot zones, and we named several of the hot zones in areas of New York, Baltimore, Los Angeles, and other places. There is a significant ring of fraud that we have identified and are working to rout out.

The papers that I handed you to show you talk about the hundreds of actions we have taken in Chicago, we have taken in Florida, we have taken in New York. So I appreciate that.

But let me just go back in terms of how the FHA program is doing overall. We look at our bottom line. We look at our overall loss experience, and, again, we anticipate that 1 percent of our loans this year, of the 6.7 million loans, will move into foreclosure. Now that varies by State to State. We have a few States which have high, intense loss experience, but in your own State, for example, we have only 17,000 loans. About 100 of them will go into foreclosure, a foreclosure rate of less than .6 percent. Michigan, if Senator Levin was here, is about the same as Maine. So many of the large States, many of the small States across the board, we see very little evidence of any substantial run-up in the kind of foreclosure problems that your Subcommittee is focused on.

Senator COLLINS. But wait a minute. Flipping does not always lead to foreclosure. There are many, many homeowners out there who are continuing to struggle and make those mortgage payments who are still victims of property flipping scams. We heard from one yesterday.

Mr. APGAR. Right.

Senator COLLINS. Mrs. Pratts is still making her payments.

Mr. APGAR. Yes. When people have faced the combination of a poor home condition and a high price, that puts a lot of pressure on them. Some owners hang on as best they can. Many of them move into foreclosure, but, again, we are not aware of any information that provides any extent of this. We look through our own files, and we can identify—where we identify examples of a fraudulent appraiser, and that is why we are bringing action against some of the appraisers across the country.

Senator COLLINS. So are you standing behind your press statement that this is just an isolated problem and it is no big deal, essentially?

Mr. APGAR. No. I never said it was not a big deal.

Senator COLLINS. You said it was isolated, that it was just isolated examples.

Mr. APGAR. Right, the flipping problem is isolated to these hot zone areas.

Senator COLLINS. How can something that is occurring in cities all over the country be called an isolated problem?

Mr. APGAR. Well, like I said, it is an intense problem in the cities that you mentioned. It is not a particularly substantial problem in other places, but I do expect with 6.7 million homes on the market that you could go back and find examples of abusive practices across the board, one here, one there, but the concentration and the ring of this kind of fraudulent behavior is what we are working hard to crack.

Senator COLLINS. Well, I have to say that your answer just heightens my concerns. If you do not concede that this is a widespread problem that is causing a lot of trouble for thousands of home buyers across the Nation, then I really question whether HUD is committed to solving the problem. If you do not admit the extent of the problem——

Mr. APGAR. I am saying look at our actions, please. We have worked hard for 3 years to put aggressive programs in place. We have taken aggressive enforcement actions. We have developed new systems and new procedures and that evidences the fact that we take it very seriously. As I said in my statement, one victim is one too many, and we will work hard to make sure that nobody is victimized in the FHA programs, and so I just reject the idea that we do not take it seriously.

My staff and I work on this on a regular basis, and it is our No. 1 priority, and, again, our actions demonstrate that we are making substantial progress.

Senator COLLINS. Well, let me ask you about another comment that you made to the press with regard to these hearings. This was part of a news story written by the *Dow Jones News Service.* It says: "FHA Commissioner William Apgar defended HUD's oversight and belittled Senator Collins' hearings," and quote, "This is just show-boating in order to make cheap political points."

You did not attend yesterday's hearing. So I want to show you some of the excerpts of the very disturbing testimony from the three victims that appeared before the Subcommittee and see, perhaps, if it alters your view of the importance of these hearings. We will roll the tape.[1]

[Video presentation.]

Senator COLLINS. Mr. Apgar, when I heard those statements, they broke my heart, and there were scores, there were hundreds, there are thousands of home buyers who are exactly in the same position as those three women, and if you think these hearings are show-boating and an attempt, as you clearly were quoted in the paper, to make political points, you are sadly mistaken. We have a serious problem, and I would expect that HUD would want to join me, Senator Mikulski, Senator Sarbanes, Senator Durbin, Senator Bond, and others who have expressed concern in trying to solve this problem rather than attacking us for exposing it.

Mr. APGAR. I share the importance of the problem. I, myself, have talked to many victims in my own travels to Chicago, to Baltimore, to New York, and around the country. These are heart-wrenching stories, and there is no doubt about it. The bottom line here, though, is what we plan to do about this. We have an action agenda at HUD, and we are moving. Many of the people who have been victimized, we have a plan to help make them whole, the most aggressive victim relief program in the industry today.

Many of the people who perpetrated the fraud are now out of business because of HUD actions, and so I appreciate the fact that we are working with Senator Sarbanes, we are working with Senator Mikulski, and we would be very happy to work with you to take these hearings and turn them into something productive, con-

[1] Exhibit No. 17 is retained in the files of the Subcommittee.

crete actions that this Congress can take to help eliminate the predatory lending from our mortgage industry.

Taking up the Senator Sarbanes bill would be a good first step. Taking up the efforts to protect Credit Watch would be another step. Making sure that the HUD budget is fully funded so that we can do the kind of counseling that we need to do is a good step, and so I think that we have a lot of work to do, and I am glad to see that you are willing and able to work with us at HUD as a partnership, because we have a plan, and we just need your support to make it happen.

Senator COLLINS. Well, let us take a look at one of your plans. We have heard from Ms. Rollins in her testimony, the last question that she posed or that I posed to her, that she and many of the other flipping victims whom we interviewed told us that the fact that the Federal Government was insuring their mortgage made them think that everything, surely, would be all right. After all, if the Federal Government is standing behind my mortgage, surely the Federal Government is not going to allow me to buy a house that is crumbling; it is not going to allow me to be a victim of a fraud and is going to stand behind me as the home buyer.

You heard her say that, that one reason she went forward, despite her reservations, is that she could not imagine that there would be a problem when HUD was insuring her mortgage. They assumed, these home buyers assumed, and it is a very logical assumption for them to make, that the Federal Government would not agree to insure the mortgage if the property was not worth what they paid for it and if it was not livable. That is a logical assumption for them to make.

In addition, as you pointed out in your testimony, I think you said in your written testimony it is something like 80 percent of your portfolio who are first-time home buyers, and that is the whole point. We are trying to help these people who do not have the experience, who are the first-time home buyers. So I think it is very logical for them to draw the conclusion that if the government is standing behind the loan, they are standing behind them as the home buyer.

Now I want to show you an ad that HUD has recently produced that we happened to see on CNN.[1]

[Video presentation.]

Senator COLLINS. This promises home buyers, "If any problems are found, you will know about them before you close," and I am really concerned that through this ad, HUD is perpetuating the false assumption that home buyers can believe that the process HUD is using is going to protect them. Another problem I have with this ad is the implication that the appraiser is going to do this kind of in-depth inspection that a home inspector would conduct. Your own form, you have a good form that you have recently changed.[2] I have the updated version that says: "For your protection, get a home inspection." It is much stronger than your earlier forms, and I commend you for coming up with that.

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[1] See Exhibit No. 13. Exhibit No. 13.a., a transcript of video, appears in the Appendix on page 232. Exhibit No. 13.b. is retained in the files of the Subcommittee.

[2] See Exhibit No. 10 which appears in the Appendix on page 229.

This form makes very clear that an appraisal is different from a home inspection. It encourages the home buyer to get an inspection, and appropriately so. It makes clear that an appraiser is not an inspector, that an appraisal will not evaluate the physical condition of the house. It will not look at the mechanical systems. It will not identify the items that need to be repaired or replaced.

It explains the difference, and yet your ad seems to foster exactly the opposite impression. It says that you can count on the appraiser to find out if there are problems with the house. I do not understand why you would be running an ad that gives home buyers this sense of false security that confuses them about the role of the appraiser and the role of the home inspector.

Mr. APGAR. Well, let me just first comment on the role of the FHA appraiser. It has always been different. Our appraisers are required and have been for some time to note down any readily observable conditions that differ from FHA minimum property standards. That is not the same as an inspection, and we are clear, as we note there, but the conditions that were in the homes of the three victims certainly would have been readily observable by an appraiser doing his job, and under our new system that we have in effect, the home buyer would be notified of what the appraiser observed.

They would observe the fact that the roof was a patched-over tar job, and the useful life of the roof would not have been more than a couple years, as opposed to the buyer who believed the roof was good forever. The appraiser can note that. The appraiser could turn the lights on and off and note that the electrical systems were not adequate. The appraiser would have observed conditions of the raw sewage that you mentioned. These are readily observable appraisal concerns.

The appraiser is a responsible agent, if you will, of FHA that goes in the property and notes that. We clarify that for the home buyer. We give them the information from the appraisal report that says here is what the appraiser observed. That report then says you should go and get an inspection, just as the form did. In addition, we worked collectively with the appraisal institutes and others to launch a national campaign called For Your Protection, Get a Home Inspection, where brochures about the role of the appraiser, the inspector, and how to use an inspector properly, as does our home buying counseling.

So we are aggressively encouraging households to get inspections, but we are also taking advantage of the fact that, as a professional, an appraiser in the home can make observations about readily observable defects and that the homeowner ought to have that benefit too.

Senator COLLINS. Mr. Apgar, in guidance that you put out to all of the FHA-approved appraisers in a letter dated November 12, 1999 that came from you, you tell the appraisers that you are not acting—"the appraiser, in performing the appraisal of the property, does not act as a home inspector."

Mr. APGAR. That is true.

Senator COLLINS. And I quote, "It is not the responsibility of the appraiser to guarantee the condition of the house, its equipment, appliances, or to certify that the property is free from defects."

Mr. APGAR. That is also true.

Senator COLLINS. Rather, the appraiser is required to make reasonable observations that are immediately discernable, not required to move any furniture or any equipment. It would not have detected the problems in the heating systems in every one of the houses we looked at.

Mr. APGAR. That is for sure.

Senator COLLINS. It would not have uncovered the plumbing problems, because those did not occur instantly.

You further go on to say that this really is not much different from what we have provided in the past or what we have asked from appraisers in the past. You said appraiser costs should not rise significantly because this really is not adding any additional requirements.

Mr. APGAR. Right.

Senator COLLINS. So how is this different?

Mr. APGAR. It is different in a couple of ways. First of all, it is different in the way it is communicated to the home buyer. Prior to the initiation of this new appraisal monitoring system, an appraisal form was only seen by the lender and was not seen by the consumer. By converting this information through the home buyer's summary sheet, these readily observable conditions, which would have been reported in the examples in the cases—I do not know, but certainly should have been reported, are readily observable conditions to warn the buyer that there are issues with this property, not a substitute for a complete appraisal—inspection, but a detailed assessment of things that were observable.

An additional piece of this is now the appraiser is held under our new guidance accountable for making these readily observable conditions. A new regulation came out clearly articulating exactly what the appraiser is responsible for. We believe that the appraisers are at the core of many of these property flipping schemes. That is why we have completely revised our appraisal procedures. That is why we are expecting the appraisers to do what they should be doing, alerting homeowners to potential problems, and why we are going after those who do not do that, and hold them accountable.

Senator COLLINS. Mr. Apgar, I do not know whether you remember the first time you bought a house. I remember very distinctly when I did. I had no idea between the difference of an appraisal versus what a home inspection was. I did not know. I did not really truly understand the adjustable rate mortgage I was getting.

When you run an ad like that, that basically tells people you do not need to worry about the pipes bursting, I mean that is the image you have in the beginning, is water flowing out of the pipes. That is not something the appraiser is going to be checking for. That is not the kind of structural review that is going to be done, and yet what that ad implies is that you can just trust HUD, and you will not have problems with your house; and I would think that would trouble you, particularly given that you are overwhelmingly dealing with people who do not have experience in this area.

Mr. APGAR. I understand your point, and if the ad were taken in isolation, but we do other things in order to encourage folks to get an inspection, and it is also true that our appraisers today, under the new guidance, are providing information to consumers that they have the capacity to make. How could any appraiser have, without looking at the conditions, appraised in the homes that you saw at the prices they did? There are defects in those homes. They are readily observable, and the appraiser has to note those defects. When they note them and provide that information to the consumer, that arms the consumer with additional information.

Senator COLLINS. Some of the defects would have been noted by an honest appraiser. There is no doubt about that.

Mr. APGAR. And then that is followed up with a caution to say this house has serious issues, you should go and get a roof person to look at that, you should go get a systems person to look at that, you should get a comprehensive home inspection.

Senator COLLINS. But the problem is that the kinds of problems you are showing at the beginning of that ad are not the kinds of problems that you could guarantee that an appraiser is going to detect. Those are the kinds of problems that a home inspector would identify.

Mr. APGAR. Our appraisers find problems like that all the time and alert our consumers. I mean, you can look at our forms and check it out.

But, trust me, I am not in any way saying an inspection is not necessary. We believe that a home inspection is an important thing, and we urge all our consumers to get it.

Senator COLLINS. Have you ever thought of requiring a home inspection as a condition of the loan?

Mr. APGAR. We have thought about that. We think our appraisal requirements are aggressive enough in order to protect the consumer in that instance, and we have left it to just strong encouragement.

Our particular concern about mandatory inspections is that we are going to mandate a requirement in an industry that is very unregulated and that it would just potentially lead to inspections at an expensive price that are not necessary, but we have under our active review this issue of mandatory home inspections. It is certainly one of the possibilities.

Senator COLLINS. I would encourage you to take a close look and listen carefully to that testimony, listen to what Stekeena Rollins told us at the hearing about her thinking she could rely on HUD to protect her, and think about the image that ad is sending, because that ad is basically telling that first-time, unsophisticated home buyer that HUD is going to protect them, and I think that you do not have the process in place to make those kinds of assurances.

Senator Durbin.

## OPENING STATEMENT OF SENATOR DURBIN

Senator DURBIN. Thank you very much, Madame Chair, and thank you, Mr. Apgar, for joining us today.

I want to say again what I said yesterday. We had three people who came and testified before this Subcommittee yesterday. I believe we let them down. When I say we, I mean all of us who are involved in public service.

We should have done a better job both at the Department of Housing and Urban Development, as well as in Congress. There are things that we can do and that we should do to protect unwary consumers from the kind of exploitation that we ran into yesterday.

I have a high regard for your Secretary, as well as your Department, and I know that you have been part of an effort to extend housing to low-income Americans. I do not think there is a nobler task in the Department of Housing and Urban Development than to give first-time home buyers the satisfaction of realizing the American dream, but what we heard yesterday is troubling, and I would like to go to a point which I asked about yesterday, and the GAO could not comment on.

There was a reorganization when it came to your surveillance of these HUD lenders that resulted in the formation of four regional centers and reduction in staff of people reviewing the FHA lenders by half. It was part of the "20–20 Reform Plan." Can you please tell me was this an initiative from the Department, or was this something Congress either mandated or reduced your funds to the point where it was inevitable? How did HUD reach a point where it put surveillance of this kind into predatory lending and did not require the number of personnel that it did in years gone by?

Mr. APGAR. OK. There is a two-part answer to that. The first part is just the factual issue, is that, in fact, the number of people doing lender monitoring has increased 7-fold over the last 4 years. So we have taken the staff we have and really focused them on an important lender monitoring task.

In terms of the overall staff cutbacks, they were a result of ongoing erosion over time due to budgetary cutbacks. We were at one time a HUD of 13,000. A decline in our Salaries and Expense funding forced us to move into layoffs and other attrition moves.

Secretary Cuomo arrived and he stopped this attrition. He said no. Even though there was some sense that HUD would move to a work force of 7,500, he resisted that and stabilized our work force now at 9,300. Although, we are concerned because the budget that was passed by the House of Representatives would force another 400 layoffs.

So we have reorganized our programs as a result of staff cutback. I do not think we have sacrificed, necessarily, the quality of programs as a result. Again, with the lender monitoring area, we are doing more lender monitoring now than we ever did, even when our staff was larger. We used automation, for example, to improve our functioning. Almost half our loans now are written through automated underwriting systems in which the computer does a lot of the work that was once done by hand. Much of our analysis of fraud and fraud protection tools are computer driven.

So a combination of automation and other things have helped us maintain our focus on fraud protection, while cutting back on the work force.

Senator DURBIN. I want to make sure the record is clear. You are saying that the number of people involved in this has grown by what over the last 4 years?

Mr. APGAR. A factor of 7-fold. I think the particular numbers are 23, which was the number around the early 1990's, to 140 today. So 23 to 140, about 7-fold.

Senator DURBIN. These are FTEs? These are Federal employees?

Mr. APGAR. Full time in terms of lender monitoring. The number of lender monitoring reviews have increased by a factor of four. Our lender monitoring reviews are more in-depth. We are asking people to stay longer and do more in-depth analysis at the site.

Senator DURBIN. These are not independent contractors or private contractors?

Mr. APGAR. No. These are HUD employees, and as a result, the number of referrals—again, before you arrived, I submitted for the record just the number of referrals we did in the three States where the women from yesterday came from, New York, Florida, and your own State of Illinois. We have literally hundreds of referrals to the IG, to other agents, as well as referrals to our own bodies, the Mortgagee Review Board and the like, and this list is just in the last 15 months.

Senator DURBIN. I believe our notes indicated that Easy Life in Chicago had been cited and fined by FHA prior to Ms. Rollins' bad experience. What kind of efforts do you make to ferret out these bad actors based on actual penalties and proof of violation?

Mr. APGAR. Well, the automated system, the Credit Watch system is a performance-based system. So it is very quick. When we identify a lender who has a high rate of defaults and claims relative to the peers in that metropolitan area, we terminate them and do not need to have a lengthy process. Our mortgagee review process is more of a quasi-judicial process, an administrative hearing board.

Again, the number of cases coming through the mortgagee review board are substantial, and when we identify people, we do one of several things. We can ask them to indemnify us for the loans, i.e. make FHA whole. We can impose civil penalties against them, and/or we can debar, suspend them for various lengths of time.

Just last week, we had a major case in New York where we debarred one of the larger lenders in the area who had a record that was very poor, and we managed to suspend that lender, the principal, hit him with a pretty good fine. Those deterrent efforts, we believe, are sending a signal through the mortgage industry that we mean business.

Senator DURBIN. You said in a public comment about this hearing that you thought what we found yesterday was isolated. You were kind enough to meet with Ms. Rollins and her attorney, and her attorney probably told you, as she told me, that she represents some 200 home buyers——

Mr. APGAR. Right.

Senator DURBIN [continuing]. Who were exploited by this one operation. So do you still maintain that this is an isolated situation?

Mr. APGAR. Not in South Side Chicago, it is not. It is a big problem there. What we see when we look at our detailed information is you can see these scams just emerge. As a combination of a broker, a lender, an appraiser, and lax oversight by other State and local officials, allow these scams to take hold and grow. So we will see heavy foreclosures, heavy defaulted mortgages and the like.

We are able to go in with the help of FBI and others, rout some of that out. So in the blocks where it is happening, it is not isolated. It is all pervasive.

Senator DURBIN. So when does the red flag go up? When does HUD first have a suspicion that a lender or an operation is exploiting or deceiving consumers?

Mr. APGAR. Well, in our current system, we collect appraisal data on line. We are monitoring the work of appraisers. As soon as we have a couple of indications that there is suspect of an appraisal—maybe because the appraisal seems out of line with the data we have on prior sales, maybe it is because the appraisal seems out of line relative to other indicators—we then bring our appraisal monitoring teams in. We do a review of all the recent appraisals they have done.

And, again, that system is just reaching its full maturity. Last month, 40 appraisers were sanctioned as a result of that program. So that is one way. Another way is tips and other things, individual complaints. We are able, through our data base, then to run and see how the other loans that that lender that was involved in the initial accusation occurred. I believe that is how we got many of the lenders in New York—a tip from a group that was being scammed from some non-profits.

Senator DURBIN. You mentioned in your testimony that FHA is doing a better job of serving African American and Hispanic borrowers, and two of our witnesses yesterday were African American, one from New York and another from Chicago. I am told that the data collected by HUD, perhaps not in your agency, suggest that there is a higher incidence of sub-prime lenders, even in neighborhoods of comparable income, when it comes to African American and Hispanic borrowers.

Mr. APGAR. Right.

Senator DURBIN. And I would imagine, then, if you go to the next subset of first-time borrowers, you can put all of this together, the outrageous interest rates on the mortgages and the exploited practices for people who are brand new to this business. I mean, when I listened to the witnesses yesterday explaining their lives in these dumps that they had been swindled into purchasing, and it was heart-breaking, but it also told a story that for many of them, they had never owned a home before and really did not know much about a home in terms of how it operates. There is no super to call.

Mr. APGAR. Right.

Senator DURBIN. You may have to buy your own little tool box to try to deal with some things, and you have to be conversant with items that a lot of homeowners just take for granted, and for a lot of these people, it is not part of their life experiences. They have never done it before, and I think that is a reality.

What is FHA doing in those situations? I mean in terms of being vigilant and not waiting, perhaps, for a red flag, but anticipating some areas where you are going to have a high incidence of exploitation?

Mr. APGAR. Well, exactly, our home buyer counseling program of course is part of a broader effort of this administration to promote financial literacy among the low- and moderate-income families. It is just not about mortgage lending. It is about use of credit cards debts, other ways, the banking system. So there is a broad set of issues.

We have a national network of home buyer counselors that provide home buyer education. We incentivize them to participate in FHA programs. So we believe home buyer education is one of the first steps.

In terms of the national task force, one of the recommendations was to launch a national public service ad campaign to alert people to the fraudulent practices that are out there. Baltimore has such a program. Boston has one, and we are thinking about how to make that go national. I mean, the people on TV pushing these bad programs every night on the night movies and the late night TV, we ought to be on there with, saying, Hey, pay attention, do not borrow trouble; think about what you are doing before you are here; if it looks too good to be true, it probably is; call somebody, call your church, call whatever to get some honest advice before you get caught up in one of these scams.

Senator DURBIN. Now, what is this hot zone that you have made reference to?

Mr. APGAR. Hot zone is a focus where our data suggests there is high share of defaults, people in arrears with their mortgage or a high share of foreclosures. That is a place where we can concentrate our resources for workouts, loan loss mitigation. We can focus our enforcement tools to try to identify who are the lenders or the appraisers, the brokers who are getting people involved with this trouble.

Senator DURBIN. My last question to you, and I see my time is up, concerns the situation with the Easy Life Realty and the loan operation that exploited Ms. Rollins. What does HUD or FHA do, if anything, to follow through on the licensure of the people involved in these scams?

Mr. APGAR. We can debar the appraiser from ever participating in Federal activities. We can debar the lender from ever participating.

Senator DURBIN. Is this by individual or by company?

Mr. APGAR. By individual and company.

Senator DURBIN. Both?

Mr. APGAR. The list I have is both individual action and corporate action, people by name as well as their companies. Obviously, the company part is tricky because some of these folks quickly form other companies.

Senator DURBIN. Well, what about the State licensure part of this? For instance, when I learned from the attorney for Ms. Rollins is that some of these people, these realtors who had treated her so badly were still in business in my State. That is embarrassing, and we are going to contact the Illinois Association of Realtors and the State of Illinois to try to figure out why this exists, but what does HUD do? What does FHA do as part of this?

Mr. APGAR. We notify appropriate agencies of our actions. We hope that they will follow through, but we are trying to do more than just hope. We are now piloting in Baltimore a mortgage system called MARI. I do not know what it stands for, but it is an effort by the mortgage industry to track all the bad guys and make that information widely available to others in the industry.

So they will bring the information of FHA debarrments, other State and regulatory actions together in one screen source so that everybody will be on notice of who the bad guys are, so if they are debarred in one system, you will know it in another context.

That is one step, but there is certainly a lot more room for State involvement in these mortgage frauds.

Senator DURBIN. Let me close with this comment. I have worked with Secretary Cuomo on what I think is going to be a revolutionary change in public housing in the city of Chicago. It was a subject of a lengthy negotiation between the Chicago Housing Authority, the Department of Housing and Urban Development, and the families affected by these decisions. What came out of that, I thought was a realistic and sensitive approach for housing for people in low-income categories, and I believe that is in the heart and ideals of the Secretary and I believe of this administration.

What we heard yesterday is a rude awakening in terms of one aspect of the Department of Housing and Urban Development. I would never characterize it as isolated. I do not think it is isolated. I think to assume that is to assume a situation which may not even be close to the truth at this point. So I would hope that as a result of this hearing and the leadership of the Chairman in this hearing, that HUD will renew its efforts and take this as a constructive suggestion that we all have to work together a little more diligently both at the other end of Pennsylvania Avenue and up here on Capitol Hill.

Mr. APGAR. Fair enough. Today's HUD is all about making sure that the things you heard about yesterday can never happen again.

Senator DURBIN. Thank you very much.

Senator COLLINS. Thank you very much, Senator Durbin. I want to note, Senator Durbin, before you leave that according to my staff, HUD still has not taken any action against some of the individuals involved in the Rollins case. For example, the president of Dependable Mortgage and the underwriter are still operating in the loan business in Chicago, and that is troubling to me.

Mr. APGAR. Right. As I mentioned earlier, in 1996, we did refer Easy Life to the inspector general because we believed that this was criminal party involved, and we did debar the company.

Senator COLLINS. I am talking about the lender.

Senator DURBIN. What about the lender?

Mr. APGAR. The lender disappeared.

Senator COLLINS. Well, we found them.

Mr. APGAR. What?

Senator COLLINS. They are still operating in the loan business in Chicago. So we will help you find them.

Mr. APGAR. No. The lender, we took action against the lender, and the lender went out of business.

Senator COLLINS. The lender, Dependable Mortgage—you are right—no longer exists, but the principals of Dependable Mortgage have simply gone on to another company, and that is the whole point.

Senator DURBIN. That is the point. What is your answer to that?

Mr. APGAR. The answer, we took action against Dependable Mortgage. If the new lender is engaged in deceptive practice, we will take action against them.

Senator DURBIN. John Smith, President of Dependable Mortgage has now done so many terrible things that HUD and FHA have decided that his Dependable Mortgage company is no longer eligible for FHA. John Smith says it breaks my heart. I just spent $200 with my attorney, and now we are the Ultra Dependable Mortgage.

Mr. APGAR. Right. I hear you. John Smith should be in jail, and we should not do business with him.

Senator DURBIN. Well, the question is what is your action? Do you have a way of taking action so that John Smith is tracked from this point forward, as opposed to the name of the next company or the last company that he worked for?

Mr. APGAR. We track each of our lenders, and if it is current business—if he goes back into business, we can stop him, and then we can permanently debar him as an individual.

Senator DURBIN. As an individual?

Mr. APGAR. Yes.

Senator COLLINS. But that has not happened in this case.

Mr. APGAR. You could be right on that.

Senator DURBIN. Would you look into that?

Mr. APGAR. Sure will.

Senator DURBIN. I am glad the Chairman brought that up, and I really hope we can follow through and get a good answer on that, because there is no reason why these people should continue to do business.

Mr. APGAR. In Chicago, we work with the community groups who give us particular names all the time, National People's Action and others, and so that is one of our main sources of evidence on who the bad guys are, and we are taking, as I said, in this list hundreds of actions in Chicago. I do not know if we took action against this particular person or not.

Senator DURBIN. Thank you.

Senator COLLINS. Mr. Apgar, I just have a couple more questions for you. One of the concerns I have about the latest plan that you have unveiled to try to crack down on these predatory lending practices and property flipping is that when I look over the past 7 years, I can count at least 12 reports or audits that have criticized HUD's management of the single family program.[1] Repeatedly, HUD has been put on notice by its own IG, by the GAO, by outside auditors that its programs are vulnerable to fraud.

Why is it taking so long for HUD to propose improvements to crack down on the fraud? I mean why, I have got reports that go back to April 1993, May 1995, February 1997, March 1997, July 1997, another July 1997, March 1999, April 1999, January 2000, February 2000, March 2000, and April 2000. This makes me question whether or not HUD is really going to take sufficient action and be committed for a sufficiently long time to solve this problem when 7 years of reports and we still see the problem today.

Mr. APGAR. Well, I mean, we could go back even further into the mid-1980's when the Department was a total mess. The FHA fund was nearly bankrupt during the 12 years that preceded the arrival of the Clinton Administration. In 1990, the fund was so poorly managed that it was $2.7 billion under water. We did not have enough to even cover the claims for the insurance that was out-

[1] See Exhibit No. 18 which appears in the Appendix on page 314.

standing, much less make new loans, and so a lot of time was spent digging out from the mess that was inherited. That is no doubt.

Senator COLLINS. Well, there was a significant premium increase for the insurance fund that helped make the insurance fund look better.

Mr. APGAR. Well, I would like to submit for the record the facts about the premiums, because I understand that came up yesterday.[1] In fact, the premium, which was legislated, mandated as the maximum, was set at 3.8 percent, the front-end premium, and since then, it has dropped almost 40 percent to about 2 percent today. We have a couple different premium structures, and so, in fact, we have cut the premiums substantially as we have been able to make the fund more healthy by our improvements.

And, again, today the fund is in its best financial shape ever. This is not us speaking. This is our own independent auditors and an independent actuarial study that suggests that FHA has an economic value of $16 billion, up from the minus $2.7 billion just a few years ago. So there has been improvement, not to say that we did not get a big jump start when Secretary Cuomo arrived with all his vigor and commitment as being zero tolerance for waste, fraud, and abuse. We really, in the last 3 years, put a major amount of energy into restructuring all our systems so we can protect the folks that were testifying today from abusive practices.

Senator COLLINS. For the record, I am going to follow up with some questions on what this administration did in response to each of these reports, but in the interest of time, I will ask that the——

Mr. APGAR. If I could make one request to you, yesterday when I was reviewing the reports of the testimony, it seems to me that these are very complicated matters, and in a give and take, there can be many misstatements and misperceptions. So I would like to request the opportunity to review the report myself and point out any inconsistencies on how we see it.[2]

Senator COLLINS. We would welcome any materials. We want to make sure we have the fullest possible understanding.

Mr. APGAR. Right, because, again some of these issues are pretty complicated.

Senator COLLINS. They certainly are, and HUD has a lot of explaining to do. So I look forward to getting your comments on all of the testimony, and we will happily share with you the hearing record from yesterday.

Let me ask you one final question. We have talked a little bit this morning of the position of debarring or suspending or otherwise taking enforcement action against those individuals who are ripping off the FHA program, but equally important, as the GAO testified yesterday, and as its April report of this year demonstrates, is making sure that bad actors do not get into the program, in the lender program in the first place. I want to talk to

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[1] See Exhibit No. 16 which appears in the Appendix on page 313.

[2] On July 11, 2000, Assistant Secretary Apgar was provided with copies of the Permanent Subcommittee on Investigations' June 29 and 30, 2000, hearing transcript for his review and comment as well as a copy of all prepared remarks of witnesses and the General Accounting Office Report on this matter. On August 3, 2000, the Subcommittee received and incorporated into the record editorial changes to Assistant Secretary Apgar's testimony of June 30, and materials on *New York City, Chicago and Florida Lending Activities/Actions Taken* (See Exhibit No. 15 on page 296) and *FHA Premium Policy* (See Exhibit No. 16 on page 313).

you just briefly about the process that HUD uses for granting direct endorsement authority to lenders.

GAO did an in-depth investigation, looking at the front-end process and found that in the 6 months prior to its office visits to the four homeownership centers, that the centers granted direct endorsement authority to a total of 36 lenders. Now here is the part that troubles me: Fully one-third of the lenders, 12 of them who were granted the direct endorsement authority got poor ratings from HUD when HUD was reviewing the 15 mortgages that they are required to submit for review. Poor ratings, and yet they received the direct endorsement authority anyway. I do not understand that.

How can a lender who does not pass the threshold test at the front end be given the authority by HUD to underwrite these mortgages without HUD's review?

Mr. APGAR. OK. Our rules for the direct endorsement system, a lender submits to us loans in their initial work, and we rate them. When we identify a loan that is judged poor, we talk to the lender and help them understand what part of the process they did not understand. We continue that process until the judgment of the review staff that that lender is fully capable of managing these loans.

In some instances, a poor rating may be a minor issue. In other instances, it may be more substantial, but in any event, we continue to work with them until they are able to demonstrate sufficient understanding and capacity to exercise this responsibility. Then—and the part that was not mentioned at all in the GAO report—we continue to monitor that lender through the next 50 loans or 180 days with a complete review, and at that point, a lender can be, in fact, sanctioned or not allowed to continue on with the program. And, finally, of course, some direct endorsement lenders are removed from the program and put back on either 100 percent review of these so-called post-technical reviews or remove their direct endorsement authority entirely.

Again, in the papers I submitted, I give you examples in each of the cities of lenders that have in the last 15 months been treated with all those remedies, put on 100 percent post-technical review, removed their direct endorsement status, and, of course, ultimately in the sense of lenders that are not performing, we move to sanction them and terminate them from the program.

Senator COLLINS. Well, you have been misinformed, apparently, about the 12 lenders that I am talking about, the one-third of the cases, as GAO said very clearly yesterday these were not minor errors. These were not paper-work problems. They were significant deficiencies.

Mr. APGAR. I reread the report on that point. They said the types of——

Senator COLLINS. Well, you did not hear the testimony, the exchange I had where I followed up.

Mr. APGAR. That is an area of qualification I would like, because the testimony was inconsistent with their own written report. The written report identified four areas and four examples of what were poor, but there was no evidence and no indication that the lenders had committed the worst part of those things. Some might have. Some did not.

Our own understanding, looking at the greater detail of that report and talking with follow up, is that it is a range of types of activities.

Senator COLLINS. Well, that is not what GAO said yesterday, and I would also indicate to you——

Mr. APGAR. Well, again, I just encourage——

Senator COLLINS. If you could let me finish my sentence, and then I will let you finish yours.

Mr. APGAR. I am sorry.

Senator COLLINS. GAO said that these were not minor problems, but rather they were basic fundamental and serious errors, such as failing to verify the buyer's income, and that the procedures being followed would not ensure that the loan was appropriate. They were serious errors, and my point to you—I mean, if you are satisfied with the front-end system, I think we have got another real problem here.

Mr. APGAR. No. We took many of the GAO recommendations to heart and are, in fact, working to tighten up the front-end system. What we disagreed with is the characterization that this suggests that we were in a very lax way letting totally unqualified lenders into the program. We do not believe that to be an accurate statement of the facts.

On the other hand, they had many excellent suggestions on how we can improve this process and we can, in fact, implement them.

Senator COLLINS. Well, I am glad to hear that last part, because I think GAO did an outstanding job on this report and that they identified many weaknesses in the process at the front end and in the reviews, and I might add that GAO also identified more than 200 lenders nationwide during Fiscal Year 1999 who received poor ratings for mortgage credit analysis on more than 30 percent of the reviewed loans. That is troubling and nothing happened in those 206 cases. HUD did not take any action.

Mr. APGAR. Right. We use that information in our new system to target lender monitoring reviews. Again, the GAO mentioned but did not elaborate on our new effort to track the post technical reviews and use them as a targeting device, the so-called ART system.

Senator COLLINS. Mr. Apgar, I hope that you will take to heart the testimony that you have heard. We are happy to give you the hearing record, because I very much want you to read the hearing record.

I hope that you will commit yourself to recognizing that this is a serious, widespread problem that it is not isolated, that it is something that is going to require the joint and cooperative efforts of us all to solve. I am aware of your Credit Watch program, which I think is a promising program, is under attack in the courts. If we can provide a statutory basis for that, that is helpful, that is something I am certainly willing to help with, but I have to tell you that I think your whole approach to these hearings has been extremely disappointing, and it raises questions in my mind about whether or not HUD is interested in just PR, such as that ad, or really solving the problem.

So I hope you will commit today to working with us and to working with your IG and GAO in a cooperative effort, because I think both of us, all of us share the goal of making sure that these home buyers are not exploited, and that is what is happening now, and we just have to do everything we can to put a stop to that.

It is not just losses to the insurance fund. Those concern me as well, but what concerns me even more are these home buyers who, rather than living the American dream, are finding that their dream of homeownership has turned into a true nightmare, and I would hope that that is something we could all agree is a common goal of preventing these kinds of scams and fraudulent schemes.

Mr. APGAR. Well, I certainly look forward to working with you and others who want to join us in our efforts to end abusive practices in the FHA or any other mortgage market. So I appreciate that.

Senator COLLINS. Thank you. I am now pleased to welcome our final witness today, Susan Gaffney, who is the Inspector General of the Department of Housing and Urban Development. The Inspector General's testimony will include the historical causes for HUD's present problems with flipping and mortgage fraud, and I very much appreciate the great work that she and her office has done on this issue. I would ask her to come forward and to introduce the two individuals who are accompanying her.

Before you get comfortable, I do need to swear you in.

Do you swear that the testimony that you are about to give will be the truth, the whole truth, and nothing but the truth, so help you, God?

Ms. GAFFNEY. I do.

Ms. KUHL-INCLAN. I do.

Mr. KESARIS. I do.

Senator COLLINS. Ms. Gaffney, welcome, and I look forward to hearing your testimony. You may proceed.

## TESTIMONY OF SUSAN GAFFNEY,[1] INSPECTOR GENERAL, U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT, ACCOMPANIED BY KATHRYN KUHL-INCLAN, ASSISTANT INSPECTOR GENERAL FOR AUDIT, AND PHILIP A. KESARIS, ASSISTANT INSPECTOR GENERAL FOR INVESTIGATIONS, U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

Ms. GAFFNEY. Thank you, Madame Chairman. I would like to introduce, as you suggested, Phil Kesaris, who is our Assistant Inspector General for Investigations; and Kathy Kuhl-Inclan, who is our Assistant Inspector General for Audit. They are the real experts and are available to help me with this hearing.

I would like to commend you and the Subcommittee for your interest and concern about the flipping issue. I would also like to commend Senator Mikulski and John O'Donnell, who is a reporter for the *Baltimore Sun.* They have also done a lot to raise awareness of this issue and to galvanize HUD into some action.

Senator COLLINS. I certainly agree with your comments.

Ms. GAFFNEY. Over the past few years, single family fraud, including flipping, has become a major component of our investigative workload, and I think it is fair to say that the growth in these cases is to the point where it is about to overwhelm the resources

[1] The prepared statement of Ms. Gaffney appears in the Appendix on page 107.

of the OIG and the U.S. attorneys who have to prosecute these cases.

What we have learned from our flipping investigations is as follows: First of all, the Secretary and Mr. Apgar talk about predatory lending, and typically they talk about predatory lending as a phenomenon in the sub-prime lending market. We are not talking about sub-prime lenders here. We are talking about FHA-approved prime lenders.

Second, we have forever seen fraud in the single family program, but it is only recently, only in the past several years, that we have seen this phenomenon of flipping. It is new. It is not historical. This is not business as usual.

Another point about flipping is that it typically involves collusion by multiple people. This is not like your deciding to commit fraud on your own by making a false statement on your income tax return. These flipping deals require collusion by multiple people, and further, these multiple people tend to be quite professional in perpetrating the frauds. Their actions tend to be quite orchestrated, and to give you an example of that, in December 1999, a U.S. attorney in central California announced 39 indictments of persons who were involved in massive flipping and fraud, and all of those cases rested on our having identified one person whose full-time occupation was generating forged documents to be used in obtaining FHA insurance.

My point here is that this is not casual fraud. This is not seat-of-the-pants fraud. This is orchestrated. This is collusion. It is, as you have said, also distinct from other types of single family fraud because this does not just harm the mortgage insurance fund. It destroys human beings, and there is no doubt that you are right that they still believe in their government, and they still believe that if their government is standing behind a loan, it is a good loan.

The other area where we have a difference with Mr. Apgar: He said these are isolated problems. We find, in fact, that flipping is pervasive. We have open flipping investigations now in 14 States. Perhaps the best indication of the pervasiveness is we started, about a year and a half ago, a new initiative called the Housing Fraud Initiative in six judicial districts. We now have 139 open single family fraud cases in those six judicial districts, and half of them involve flipping schemes. This is all over the place, and when we find evidence against a particular lender, a particular appraiser, typically what is happening is they are saying, Well, OK, you got me, but guess what, I know 10 or 20 other people who are doing the same thing.

So not only is it pervasive, but it is not a secret. They all know what is going on, and in this day of the Internet, it is simply foolish to think that some people have an enormously profitable scam, and nobody outside those isolated little centers knows anything about it.

Your concern about flipping led you to ask GAO to do a review of the single family loan origination program. Our concern about flipping and single family fraud led us to do an audit of the same area. We, in addition, looked at two major cases of fraud and went back and did specific audits to try to find out why such massive frauds could be perpetrated without HUD's having detected them. I think it is fair to say that all of these audits have reached the same conclusion and that is that the internal controls that should be working in the single family loan origination program to prevent fraud, waste, and abuse really are not working effectively, and, of course, that is the same boring message that IGs always convey and it does not have a lot of pizazz.

I actually thought that our two follow-up reviews on specific frauds had some pizazz. In the first case, Allstate Mortgage Insurance, we had a situation where Allstate generated 400 fraudulent mortgages valued at $97 million. So we went back into the homeownership center to say, how could this possibly happen with no one finding any indication of it at all? And what we found was that, in fact, 17 of these loans had been subject to post-endorsement review by a contractor to HUD; and the contractor's reviews were severely, were grossly inadequate. The contractor reported no problem with these loans, even though there were blatant examples of fraud in the case file.

The other instance of fraud was not flipping, but it was a case where a HUD employee was responsible for selling HUD property that was valued at $9 million. She sold it for $2 million, and this went on for over a period of a couple of years, and no one in HUD detected it. We found out about it from outside of HUD, and when we went back to HUD to find out how in heaven's name could this happen and go undetected, the answer was that this employee was subject to no supervisory review at all. She unilaterally made these decisions, made these sales, and they were not subject to review by anyone else. That is $9 million worth of sales for $2 million.

So HUD's reaction to this situation, the investigative cases, and the audits has been 3-fold. First, HUD mightily proclaims that the mutual mortgage insurance fund is in the best shape ever, and I am not here to dispute that. The latest actuarial study certainly puts the fund on sound footing. I do not think, though, that any of us would say that because the fund is on sound financial footing, we are perfectly prepared to tolerate fraud against the government and against individual victims, at least I hope not.

Second, HUD's reaction has been to announce a series of new initiatives that you have discussed, such as Credit Watch, the certification of FHA appraisers, a new centralized appraisal review system, and the restructuring of flipped mortgages down to the true value of the properties.

And HUD's third reaction has been pretty extreme defensiveness with respect to the GAO and OIG audit findings.

So let me go through these three HUD responses very quickly. First of all, as I said, the MMI fund is in good shape, but what does that have to do with stopping fraud? Second, we think the new initiatives, as you have indicated, are generally good ideas. We have not seen the results, and HUD is notoriously good at planning new initiatives so that we are always looking prospectively, but my important message to you today is these initiatives cannot substitute for the day-to-day work that is being done by the homeownership centers. The controls that we need to have are there. They are in the day-to-day business. They are not extra, added endeavors off to the side, and after the fact. I am not opposed to those things, but they should be building the fundamental internal controls in the business operations.

With respect to HUD's defensiveness about the audit findings that we lack adequate internal controls in the business operations to prevent waste, fraud, and abuse—I really do not understand why they are so defensive, because if you stand back and look at the situation, what has happened over the past few years? What has happened is the volume of FHA loans has increased very substantially. The FHA underwriting standards have changed very substantially. The single family staff has been cut in half, and it has been dramatically reorganized. It is any surprise to anyone in light of those facts that they do not have their act together very well?

I say that not as a negative. I say that as a plea to you and others to understand that the time has come. We must now stand back and say we have been through all of these changes, we have problems, let us allow the dust to settle, and let us figure out how to make the program really work to prevent waste, fraud, and abuse.

Now, it is going to be boring to do that, because it is going to require writing policies and standards. It is going to require training people. It may even require obtaining more resources and people from the Congress, but until we take on the real task, we are just playing at the edges.

Thank you.

Senator COLLINS. Thank you very much for your very helpful statement, and, again, I want to commend you and your colleagues for the excellent work that you have done in this area.

And one of the reasons that I feel very uneasy about HUD's commitment to solving this problem is to have Mr. Apgar sit here and continue to maintain that this is just an isolated problem when you are in 14 States, and whenever where we looked, every single city where we investigated, we easily found evidence of flipping schemes. It just seems to me that the denial of the extent of the problem does not bode well for concerted effort to solve the problem, and your testimony is very helpful.

I think you also raise an excellent point about the insurance fund. Just because the insurance fund is healthy does not mean we should tolerate fraud, and, indeed, with an economic downturn, the insurance fund could be in trouble very easily. Moreover, when you look at—and there have been premium increases that were responsible for restoring the health. Is that not true?

Ms. GAFFNEY. That is correct.

Senator COLLINS. Let me ask you about a comparison of the delinquency and foreclosure rates of FHA-backed mortgages and conventional mortgages. You recently—I think it was in March of this year—issued an audit report entitled Single Family Production Homeownership Centers in which you compared the delinquency and foreclosure rates of FHA-backed mortgages with conventional mortgages, and the charts that you used—and I believe these are your charts——[1]

Ms. GAFFNEY. Yes.

[1] See Exhibits No. 11 and 12 which appear in the Appendix on pages 230 and 231.

Senator COLLINS [continuing]. Seemed to me to show that FHA delinquency rates have risen steadily over the past 5 years, and the foreclosure rate has risen even more dramatically, particularly when you compare it to conventional loans. Could you comment on this?

Ms. GAFFNEY. I am going to ask Kathy to comment.

Senator COLLINS. OK. Thank you.

Ms. KUHL-INCLAN. This information, we took from the Mortgage Bankers Association. They have been taking a phone survey of lenders for about 4 to 6 years, and our point was just to illustrate a difference between where the conventional market is going and where the FHA market is going, and we know that the FHA foreclosure and default rate will be higher than the conventional rate. Our loans tend to be of higher risk, but we expected it to be somewhat parallel, not those huge spikes, and we wanted to just make the point that there are some problems and concerns and reasons to be looking at, as Susan talked about, the internal controls and the processing of the mortgages because these rates are so much higher than the conventional rate.

We only wanted to demonstrate comparisons, and, again, just to show that there should be some parallelism between the differences, not these spikes as they are showing.

Senator COLLINS. I think that is an excellent point. As you mentioned, you would expect the foreclosure and default rate to be higher, because, after all, that is why we have the government-backed loan program, but when you see it so much higher and going in the wrong direction, and you see these spikes, it suggests to me that something else at play here, that it is not just because the loans in general are going to be riskier, but, rather, it suggests to me that there is some weakness in the system.

Is that a fair analysis?

Ms. KUHL-INCLAN. That is exactly right. That is sort of our basis for them looking at what is behind those spikes and looking at the weakness that we talked about in our report.

Senator COLLINS. Ms. Gaffney, in your written statement, you stated, “That the liberalization of FHA underwriting standards, the severe reduction in HUD’s monitoring staff, and the major organizational changes in HUD all combined to increase the vulnerability for fraud,” and it was suggested yesterday that there is a lack of resources devoted to the high-fraud areas or the areas that are most vulnerable to fraud.

The GAO, however, indicated that the changes within HUD are not so much of the result of any budgetary cutback as managerial decisions made solely by the Secretary. Could you comment on that? Are you seeing a growth in central office staff versus the homeownership centers? Could you enlighten us on that?

Ms. GAFFNEY. Perhaps I could go back to Senator Durbin’s question.

Senator COLLINS. Yes.

Ms. GAFFNEY. About whether the cutbacks in staff were the result of Congressional cutback or action by HUD. I have now been at HUD for more than 7 years, and I can tell you what I know. The cutbacks in HUD started as a result of a proposal by Henry Cisneros to cut the staff in HUD from 13,000 to 7,500. There was no basis for that proposal; there was no analysis that supported that HUD could live with 7,500 staff, but he felt it was a dramatic enough proposal to save HUD from being dismantled, and, in fact, he was right. The forces for dismantling stepped back at that point.

When Secretary Cuomo became Secretary, he and the Congress went along with Secretary Cisneros' downsizing proposal. When Secretary Cuomo became Secretary, he did not put that proposal up to question. He made a decision to continue the downsizing, and it was not until several years after he became Secretary that he took the position, I believe, that Mr. Apgar spoke about, which is we will stop this downsizing at 9,000.

As far as I know, the impetus for downsizing has been HUD, but it is true that the Congress has not disputed the HUD actions. Does that answer your question, Senator?

Senator COLLINS. It does. Has there been a growth in central office staff, in the Secretary's office, do you know, versus these other areas that have been cutback?

Ms. GAFFNEY. Well, the big area that we have had problems is the Secretary's implementing a whole new program involving some 800 people against the backdrop of HUD's major downsizing. For the Secretary to set up a new program involving 800 people is quite extraordinary. That program is called the Community Builders Program. We did an audit of that program within the last year, and our conclusion was that, principally, what the community builder program does is public relations.

Senator COLLINS. So it might be better to have those 800 slots devoted to making sure that we are policing the single family program?

Ms. GAFFNEY. Right.

Senator COLLINS. One final question for you. I have looked through your audit reports and the reports issued by GAO over the past 7 years, and one of the things that troubles me most and makes me wonder about the commitment of HUD efforts to getting a true handle on this problem is it seems to me that throughout the 7 years, the same problems are identified over and over again, and I want to give one example to you.

In April 1993, your office released an audit report on HUD's direct endorsement program. We have talked a lot about that during these hearings, and it was very critical of it. It found that sanctions were not taken, were not effectively used to protect the integrity of the direct endorsement program and that the direct endorsement underwriter approval process was not effective. Those are the exact same findings that the GAO found this year.

Is it your experience that some of the same problems that you flagged or your office flagged 7 years ago still exist?

Ms. GAFFNEY. Absolutely, and what you are specifically talking about is there is an unwillingness, historically, in the HUD programs to take actions against bad actors to remove them from the HUD programs. When Mr. Apgar talks about the Department's fight against fraud, waste, and abuse, he tends to be talking about centralized offices in HUD that have pretty narrow missions, such as the enforcement center.

Where you really need the willingness to take enforcement action is in the program areas where they are seeing the problems right at the beginning, where they can stop it, and somehow that message has not been conveyed in HUD.

Senator COLLINS. Kathy, did you want to add to that?

Ms. KUHL-INCLAN. One comment is that they do not seem to realize—when we do our audits, we are actually in the field dealing with the people at the lowest level all the way up to the directors, and they are telling us we cannot make our goals unless we look at the low risk lenders, we do not have time—we are going to take the path of least resistance in order to make our goals, in order to do our jobs.

So the idea of going after the lenders where there are indications of risk or of the appraisers where there are indications of risk is time consuming. They cannot make their goals, and what is frustrating to us is that we are saying that these frustrations are being said by their staff, and they just say, Well, we are doing a new program, or we have a policy in place, but those policies are not working, are not being used, and are not being implemented. They have to listen to what their staff is telling them.

Senator COLLINS. And it sounds like what you found is that low risk lenders will be reviewed because it is quick and easy, and you can make your numerical goal, and you do not go after the high risk lender because that is going to take a lot of work. Is that fair?

Ms. KUHL-INCLAN. It is fair, and it is not only what we saw through looking at the statistic, but it is what they told us too. So we backed up what they said by the statistics that prove it out.

Senator COLLINS. And I would add to that that you are not alone in reaching that conclusion. That is precisely what GAO found and said in its report, as well as when they talked to the individuals involved out in the field.

Mr. Kesaris, do you have anything you would like to add?

Mr. KESARIS. On the point, Senator Collins, that the flipping schemes are an isolated instance, we have 240 criminal investigators in 38 States, Puerto Rico, and the District of Columbia, and they would ask me to tell this Subcommittee that it is not isolated at all. We have seen a rapid increase in this type of scheme as the "fraud de jour" and not just in the locations where our agent-auditor teams have intensified, such as New York, Chicago, and Los Angeles, but in many, many States, and the number of complaints is just continuing to increase.

Senator COLLINS. I appreciate your adding that information to our understanding and to the record. It is evidence to me, given how hard you have all worked and GAO has worked, that we, in Congress, need to keep a spotlight on this problem if it is going to be solved, because when I read 11 different reports over 7 years warning HUD time and again of the same problems, it is evidence that Congress needs to play an active role here. I just want to thank you all very much for your assistance and for the excellent work that you have done. You really are on the front lines. You are our watch dogs, and I have great admiration for the work that you do.

So thank you very much for your contributions, and I hope you will continue to work with us as we seek to make sure that this time HUD takes this issue seriously and important policy changes and standards are implemented to crack down on this fraud once and for all. Thank you.

Ms. GAFFNEY. Thank you.

Senator COLLINS. I want to thank everyone who has contributed to these hearings in addition to our panels today. The testimony of the three very courageous witnesses who were willing to tell their stories publicly, which was obviously very difficult for them. It is awfully hard to come before Congress and admit that you were deceived, and I think those stories were very important because they put a human face on this problem, and as we go forward and seek to solve it, I think we should always remember the three women who testified yesterday, because their stories are duplicated thousands of times across this country. That is one reason that I am so committed to working with the IG, to working with HUD, to working with GAO to solve this problem.

I also want to thank the Subcommittee staff for its work on this investigation. As the IG and her staff know better than most people, and as GAO knows, this is an enormously complex subject. We have been working on this investigation for 9 months. We did extensive work on it, and the staff worked very hard.

I want to thank a few of them by name: Lee Blalack, who is the Subcommittee's Chief Counsel and Staff Director, did an excellent job. Lee is going to be leaving us for the joys of the private sector. These are his last hearings—we will miss him. Rena Johnson, who is the Deputy Chief Counsel. Karina Lynch, who regrettably is also leaving us for the joys of the private sector. We have got to do something about salaries here. Claire Barnard, Jim Pittrizzi, Ray Kessenich, and Bob Groves, who has been on detail to the Subcommittee from the HUD IG's office—we are delighted to have his expertise. Brian Jones, Elizabeth Hays, and Mary Robertson all contributed greatly to the success of these hearings. We were also fortunate to have help from three very talented summer interns—Courtney Hays, Joe Kosnow, and Adam Thomas. So I want to thank them as well.

This hearing now stands adjourned.

[Whereupon, at 12:45 p.m., the Subcommittee was adjourned.]

# APPENDIX

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**Statement of Senator Barbara A. Mikulski**
**before the Permanent Subcommittee on Investigations**
**Committee on Governmental Affairs**

**Thursday, June 29, 2000**

Thank you, Madame Chair. I appreciate the opportunity to appear before this Subcommittee to give you my perspective on the problem of flipping.

Last January, I began reading stories in the Baltimore Sun about the problem of flipping in some Baltimore neighborhoods.

I heard stories about unsuspecting people trying to buy a home. About first-time homeowners learning that the house they had bought was worth less than half of what they had paid. The poor were being gouged by unscrupulous real estate agents, appraisers, and predatory lenders.

In February, I attended a meeting at St. Michael's Church in East Baltimore, where I heard about this problem first-hand.

I learned about how crooked appraisers conspire with crooked lenders to target unsuspecting first time home buyers. By providing misleading and often false information, predatory lenders, brokers and home improvement contractors were manipulating borrowers into loans that could only result in loan defaults. These loans were rife with high fees, high points and hidden balloon payments. Flippers were buying up houses and making quick, cosmetic fixes to them so they could be sold at inflated prices.

People were being robbed of their savings and what should have been the American dream, had turned into the American nightmare.

When I heard about this, I was shocked and I was outraged. The poor were being gouged, and neighborhoods were deteriorating.

As the Ranking Member of the VA/HUD Subcommittee of the Senate Appropriations Committee, I asked Senator Bond, the Chairman of the Subcommittee, if he would consider a field hearing to explore the subject of flipping and its impact on Baltimore.

Senator Bond agreed and allowed the Subcommittee to hold a field hearing- the first in over twelve years- to find out what was happening, why it was happening and what was needed to stop it.

We heard from the victims of these scams--like the woman who thought that she could own her own home for a monthly payment of just $500 per month for 15 years. But she didn't know that there was a balloon payment of $57,000 in the final year.

Our victim witnesses had a lot of courage and I want to thank them again for coming forward to tell their stories.

This isn't just going on in Baltimore, it is going on all over the country. It is a cancer destroying our neighborhoods and communities. The National Consumer Law Center estimates that over 600,000 Americans may lose their homes because they were duped into bad loans.

Three days after our field hearing, Secretary Cuomo appeared before the VA/HUD Subcommittee to present the Department's budget request for fiscal year 2001. I told him what we found in Baltimore and he was shocked.

More than 2,000 properties in Baltimore were bought and re-sold within 120 days with a 100% profit.

But even more disturbing, was the role of the Federal Housing Administration (FHA).

Unfortunately, the FHA had become an accomplice to the flippers and predatory lenders due to the large inventory of FHA owned homes that were ripe for flippers. The stock of housing in FHA's portfolio had deteriorated, and houses were available for depressed prices. To make matters worse, a lack of oversight of lenders and appraisers allowed crooked lenders to get FHA insurance.

I was so outraged that I told Secretary Cuomo that HUD needed a plan of action to deal with the problems in Baltimore and the rest of the country.

To stop the poor from being gouged and stop our communities from being destroyed.

I am proud to say that Secretary Cuomo responded immediately. He met personally with the community advocates from Baltimore and listened to their experiences.

As a result, the Secretary created two separate task forces. One task force was created to address the flipping problem in Baltimore.

A second task force was created between HUD and the Treasury Department to address the problem of predatory lending nationwide.

Yesterday, the Baltimore Task Force released its final recommendations. This task force has been one of my proudest accomplishments as a Senator.

In just six months, we have gone from anecdotal stories about something called "flipping," to a comprehensive strategy to end the gouging of the poor and the destruction of our neighborhoods.

Thanks to the work of the Baltimore Task Force, we have a clear picture about what was happening, a plan to stop it and a blueprint for future action.

I believe the Clinton Administration, through HUD and the Treasury Department, deserves enormous credit for responding so quickly and effectively to the problems of flipping and predatory lending.

I believe it shows this Administration's commitment to saving our cities and re-building our communities.

The heart of the task force's recommendations is an FHA Fraud Prevention Plan that has three major elements.

First, it calls for early detection of problem loans and problem lenders.

Second, it provides help to the victims of flipping and helps them avoid foreclosure so they can keep their homes.

Third, it identifies and prosecutes the predatory lenders and flippers so they will no longer prey upon innocent people.

This is the kind of Federal commitment I want--a commitment to stabilizing and saving communities.

Yesterday, I joined my colleague Senator Sarbanes in introducing legislation to authorize HUD's Credit Watch Program.

This legislation will formally authorize HUD's Credit Watch program. The legislation is needed to close a loophole that has allowed some flippers and predatory lenders to escape punishment.

Our bill will give HUD the power to prosecute the bums and scum with the power of law behind them. This legislation was the direct result of the Baltimore Task Force.

In the coming weeks, it will be critical for FHA to make sure that promises made are promises kept.

I believe we are already making a difference- thanks to the work of the FBI, U.S. Attorney and the hearings that have been held on this subject, we have sent a chill down the spine of flippers and predatory lenders. In Baltimore, the word is out on the street. If you are a flipper, you will be caught.

While I am proud of the work of the Baltimore Task Force, it goes hand in hand with the National Predatory Lending Task Force chaired by HUD and the Treasury Department.

The Baltimore Task Force gave us a blueprint to stop flipping, while the National Task Force gave us a blueprint to stop predatory lending.

The National Task Force and HUD announced a series of recommendations to address the problem of predatory lending on June 19.

These fifty recommendations to stop predatory lending are based on a four-point plan that gets to the heart of the problem.

First, because education is so important when it comes to homeownership, the plan calls for improved consumer literacy and counseling.

The Task Force recommends requiring counseling for certain types of mortgages and would amend the Real Estate Settlement Procedures Act (RESPA) and the Truth in Lending Act (TILA) to give people more timely and accurate information on loan costs and terms.

In their second recommendation, the Task Force zeroes in on harmful sales practices. They suggest imposing new requirements on mortgage brokers, which would prohibit abusive lending and loan flipping.

The third recommendation of the Task Force is to restrict the abusive conditions of high-cost loans. To do this, they suggest imposing new restrictions on points and fees for subprime loans and the reduction of prepayment penalties.

In addition, they also suggest expanding the scope of the Home Equity Protection Act (HOEPA) to cover the subprime market and restricting balloon payments on high-cost loans.

Finally, the Task Force recommends a general improvement for improving the way the market is structured. They suggest prohibiting Fannie Mae, Freddie Mac, and Federal Home Loan Banks from purchasing loans with predatory features.

They also recommend using the Community Reinvestment Act (CRA) to encourage lenders to move people from the subprime market to the conventional market.

I applaud the National Predatory Lending Task Force for coming up with this blueprint.

I can assure you that the predatory lenders and flippers out there know we're coming after them. We've started moving on our plan to empower borrowers, stop predatory lending and flipping, and prosecute the bums and scum that are preying on our communities. And we're seeing results.

Thanks to HUD we are re-building our communities and stopping the scourge of predatory lending from destroying the dream of homeownership for working Americans.

# LISA SMITH

**Fresh Meadows, New York**
**June 29, 2000**

★★★

My name is Lisa Smith. I am a single mother of three children and a police officer with the New York City Police Department. In February 1997, I decided that I wanted to buy a house for my family. At the time, we were living in a two bedroom apartment that was very small, and all of the children had to share one bedroom. I knew they needed their own personal space, and it would be a dream come true if they could each have their own bedroom. I had recently ended a personal relationship that had been hard on the whole family, and I thought it would give me a sense of independence to be a single mother buying my own home. I knew it would not be easy, but I had no idea about the terrible experience I was about to go through.

One day in April 1997, while looking through the newspaper, I saw a real estate ad that caught my eye. The name of the company that had placed the ad was Lenders Realty in Brooklyn, New York. The ad caught my eye because it said that their houses were completely renovated, all of the closing costs were paid, and only a low down payment was required. I thought that was great and called Lenders. Two women from the company came to my apartment. They were very nice and made me feel comfortable. They told me that all of the houses they sold were foreclosures. I didn't understand what that meant and they explained to me that the banks owned the houses. I told them what I was looking for and the price range I could afford. They told me not to worry, and said that they would make sure I got a good house that was in my price range.

They took me to a house in South Ozone Park, and explained that the house was completely renovated. In early May, we went to see the house. They said that, if I liked it, all I had to do was move in. I stood outside and looked at the yellow and brown house. It appeared to be well-kept and looked nice. My heart was beating very fast and I had a big smile on my face. I had to get myself together before I went into what would possibly be my home. When I went inside, I was so excited. It seemed like it had been renovated, and it looked new. I was the happiest person in the world that day. They saw the excitement on my face and said the house was mine if I wanted it.

I asked about the roof because it looked like it had fresh black tar on it. They told me that the roof was new, and so were the kitchen, bathrooms, bedrooms, and windows. They also explained that if there were any problems with the house, they would be repaired before I moved in. I told them I wanted the house, but wasn't sure if I would be approved for the mortgage. They explained that I shouldn't worry, and said that they would help me get a loan. They then told me that, if I wanted the house, I had to enter into a contract. I didn't know what that meant either, so they explained to me that the process of buying a house and getting a mortgage began with my signing a contract to agree to buy the house. They said I had to go right back to Brooklyn with them so the paperwork could be started. They explained that the house would sell fast if I didn't buy it quickly. I couldn't understand why there was a big rush, but I trusted them.

We went back to the Lenders Realty office and a supervisor, a woman, told me I should be so proud to have a home for my family. I explained that I needed to call a lawyer since my job would provide me with free legal services from the Police Benevolent Association. She told me that it wasn't necessary because Lenders would provide a lawyer for me. I called the PBA lawyer anyway and he told me that, after the contract was written, I should fax it over to him and he would review it. I told the Lenders supervisor what he said and she didn't seem very happy. She later told me that she had talked to the PBA lawyer and that I shouldn't use him because he had made me sound stupid and incapable of making any decisions. She also told me that I didn't deserve a lawyer that was going to bad mouth me. She told me that I should use their lawyer; that he was very good and would be acting in my best interest and wouldn't let me sign anything that I did not understand. She also told me that Lenders would arrange for my mortgage; they would take care of everything. I never knew things moved so fast when buying a house and I started to feel pressured. But, I trusted her.

In July 1997, we closed on the house. There was so much paperwork to fill out. I was really nervous because there was so much I didn't understand. I had called the lawyer before the closing and he told me not to worry, and said that everything would be okay. Then, at the closing, the lawyer hardly talked to me. When I tried to read the papers, he told me just to sign the papers. If I asked a question, he barely answered it. Then, after two hours, it was over, the house was mine. I paid $129,000.

The day I moved in was the best day in the world. My children were so excited, and they ran into the house to look at their bedrooms. But shortly after that, my problems with the house started. In August, water started to leak from the light fixture on the ceiling in my bedroom. I called a friend, who is a licensed electrician, to come look at the ceiling. He went to the roof and noticed that there was tar on the roof and explained that there was a weak spot on the roof that needed more tar. He told me that he didn't know what was under the tar or how bad the situation was. We put more tar on the roof and it seemed to work for a while.

In September 1997, I couldn't understand why the basement floor and stairs were so weak that it felt like you would fall right through the floor. Again, I had my friend come to the house and he pulled up the tile from the floor. I couldn't believe what I saw. There was a huge hole that had never been repaired. It had just been covered over with tile. I couldn't understand how someone put other people at risk of serious injury by simply putting tile over such a big hole. Lenders had told me that they had paid an inspector to look at the house, and the inspector found that the house was in good and safe condition. I started to get kind of scared, but I kept remembering that Lenders had promised to take care of everything.

Shortly after I moved in, I begin experiencing plumbing problems. I called the New York City Department of Environment Protection to complain about flooding. I also found out from a neighbor that the house had a long history of water problems and had received numerous citations from the city. Whenever we turned on the water, the pipes sounded like they would explode. On top of that, the house began to shake and I found out that the water from the upstairs bathroom was leaking down to the dining room. I couldn't afford to make all the repairs on the house, so I had to take out a second mortgage for approximately $12,000. I was now paying $1,028 per month on my original mortgage, and $368 per month on the second. I struggled to make the payments and was never late.

Then, in June 1999, the upstairs bathroom started to have plumbing problems again and water leaked all over my kitchen and dining room. I had a flood in the basement, and all my children's summer clothes were ruined. The smell in the basement was terrible because the sewage backed up. As you can see from these photographs of my house, sewage backed up everywhere. I found more holes in the floor and I was really upset. I knew one of my children could be hurt and that it had to be repaired. I couldn't afford to make more repairs, so I had to take out a third mortgage for $45,000. The third mortgage cost me close to another $600 per month. But, I continued to make all the payments.

When the weather began to get cold, the house was freezing. I would turn the thermostat up to 80 degrees but it would still read 45-50 degrees. There were nights when it was so cold in my house that I took my children to a motel. Even though I had two comforters on the beds, the children started to get sick. When the flooding began again in the winter, I couldn't take it anymore.

For a long time, I thought about the house, and about my family's safety and health. I realized the house was falling apart and I just couldn't afford to make all the mortgage payments. It was costing me nearly $2,000 a month and the condition of the house wasn't improving. So, in January 2000, I decided that as much as I didn't want to give up, I had to let go of the house. It saddened me so much because even with all the problems, I loved that house. Over the past few years, I had worked so hard to pay my bills on time, and get good credit. But, I had to declare bankruptcy and eventually lost my house. What makes it worse is that I have since learned that the owner of the house paid only $50,000 for the house in December 1996, and then resold it to me seven months later for $129,000.

I hope this never happens to anyone else. Although my credit has been totally destroyed, I feel so much better that I left the house. I would never have forgiven myself if someone had been seriously hurt in the house. I have learned that, in the future, regardless of what anyone tells me, I will read everything and ask more questions. I hope that the people who took advantage of me will learn a lesson, too. I pray that I can overcome the bitterness that this experience has created but I also know this has made me a stronger person.

I would be happy to answer any questions the Subcommittee may have.

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## STATEMENT OF
# SONIA PRATTS

Good morning. My name is Sonia Pratts. I live at 6121 Jackson Street in Hollywood, Florida. I am currently employed as an assistant manager at Senior Resource Center in Pembroke Pines, Florida. I would like to thank you for inviting me here today to tell my story.

Two years ago, my husband Carlos and I began driving through various neighborhoods in South Florida, looking to purchase our first home. Neither he nor I had ever owned a home. It was our dream to have a home of our own – a place large enough for my kids. We were not looking for luxury, but we wanted a comfortable home with no problems. We had been saving for over two years to buy our dream home.

In October of 1997, we were driving through several neighborhoods looking at houses for sale when we stopped at an open house sponsored by ERA Homeland Realty. After we looked through the house, we spoke with the real estate agent. We told him that we really liked the house, but he told us that it was out of our price range, and showed us a second house located at 6121 Jackson Street, Hollywood, Florida. He then introduced us to his boss, Joe Kuruvila, a real estate broker, who told us he would take care of us.

The first time we looked at the house on Jackson Street it was late at night. The second time was during the day, and we could tell it was being worked on. The back room was torn apart, and the front room was a mess, with lots of garbage around. There was a big dumpster full of trash in the front yard. We were concerned about the house because of all the work it needed. We told Joe that we did not want a house that we would have to spend money making repairs on because we were using our entire savings for the down payment. Joe told us that the house had a new roof and was insulated. Additionally, he told us that the entire house would have new windows and new doors, and that the walls would be as good as new. He also told us that we would be able to afford the mortgage payments for the house on our income. We foolishly trusted Joe, and signed a contract to buy the house.

One day after we had signed the contract, my husband Carlos drove by to check on the progress of the rehabilitation work being done on the house. As he approached the house, he saw a code violation notice taped to the house. He went straight to Joe's office and asked him about the violation notice. Joe assured him not to worry, and said that everything would be taken care of before we moved into the house. We did not get a home inspection because of the promises from Joe that the house would be as good as new when we took it over.

Joe recommended that we get our mortgage at Hollywood Mortgage. We followed his advice and, through Hollywood Mortgage, we got a loan with something called a "buydown." I still don't understand exactly what this means, but I do know that we had told Joe about our tight financial situation, and he assured us that under the buydown, we would be able to afford our mortgage payments.

On February 20, 1998, we went to Joe's office for the closing. Present in addition to Carlos and I, was Joe and a representative from the Title company, Gerald Chapman. We did not have a lawyer of our own because Joe told us he would take care of everything. When we finished with the closing, we were very excited. We were homeowners! Little did we know what was in store for us.

We moved into the house in February 1998. Approximately two months later, to my shock, I received a notice of code violations from the City of Hollywood. The violations included lack of permits for windows and the addition to the house. The notice required all items to be replaced or fixed. If we failed to do so, we would face fines of up to $200.00 per day from the city.

The electrical system in the living room is wired wrong. We have sockets that do not work and are not hooked up. I am concerned that this faulty electrical system will cause a fire. The rotted wood in the front room is all that holds the windows in place, and continues to fall apart. We have had so many problems with the house. It seems to be falling down around us. The living room walls are in terrible shape, and the ceilings are crumbling. As you can see from these photographs, there is termite damage throughout the house. Mice and rats enter the house through holes and, because of a lack of foundation, under the addition in the back.

The roof is another story. As you can see from this photograph, the roof is falling down and leaking. It needs to be repaired and insulated. Joe had told us that the house would have a new roof, and in fact I later found out that the roof was listed on the appraisal as new. Believe me, the roof is not new. The roof leaks every time it rains. We also have birds getting into the house, and rats crawling around. We can hear them running around at night.

The appraisal also refers to other repairs that were never done. For example, the appraisal stated that the rotted fascia and soffits were repaired. This was not done. It also said that all debris was removed from the yard. This was not done. Carlos and I worked to clean up all the garbage left behind. From my understanding, the appraisal was used to determine the value of my home. I'm not an expert, but I don't understand how this can be when so many things listed on the appraisal were not true. I also don't understand why I was never given a copy of the appraisal before closing.

After closing, we contacted an engineer to look at the house in the hope that we could fix the problems we were having. The engineer told us that the total cost of repairs would be approximately $40,000, and that the majority of the house would have to be demolished. When I heard this, I was devastated. We simply don't have the money to spend repairing the house, remedying the code violations we were stuck with, and making our mortgage payments. Because of this "buy down" mortgage that we were given, our payment has ballooned by more than $200. I am worried that we will lose the house because we are really struggling to make ends meet.

We later learned that Joe Kuruvila owned not only the real estate agency that sold us the house, but also our mortgage lender and even the house itself. We have also learned that Joe bought the house from HUD in September 1997 for $44,600, before he sold it to us in February 1998 for $80,000. In just six months, he nearly doubled his money. From what I can tell, Joe bought the house, made minimal cosmetic repairs, and then sold it to us without disclosing the hidden defects. I trusted him because he told us that he could make our dream of owning a house come true, and he said he would take care of us. Little did I know that he was holding all the cards.

We spent about a year asking Joe to correct the code violations and complaining about the condition of our house. All we heard in response were promises to make things right, but we never saw any action. Although we did not want to involve the courts, we felt we had little choice but to file a lawsuit against him seeking compensation. Our church is paying our legal fees, and the suit is presently pending in Broward County Circuit Court. We have also discussed our problems with the State of Florida.

My life and my husband's life have been devastated. At present, we are just getting by on our paychecks and could never hope to make the needed repairs or pay a fine. My husband and I have been severely damaged by all of this. Our lives are in turmoil, my marriage is deeply hurt, and what was once my dream home is now a nightmare.

I will be pleased to answer any questions the Subcommittee has. Thank you for giving me the opportunity to tell my story.

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Testimony of STEKEENA ROLLINS

Good morning. My name is Stekeena Rollins. I live in the Austin neighborhood of Chicago, Illinois, and I teach preschool children.

In mid-1995, my mother, Shirley Rollins, and I read an advertisement in the Chicago Sun-Times that said "Kiss Your Landlord Good-bye." The ad offered rehabilitated homes for sale with low down payments from a company called Easy Life Real Estate System. At the time, I was twenty years old and living on the north side of Chicago in an apartment. Neither my mother nor I had ever owned a home. I was operating a day care business from my apartment, which I was interested in moving to a home setting.

We felt we could afford the down payment mentioned in the ad. So, in June 1995, my mother and I visited the Easy Life office and met with sales agent Peter Sandow. Mr. Sandow told us that Easy Life was offering 100% "rehabbed" homes to first time home buyers through a special government program called FHA. He told us that, through this program, our down payment would only be $500. He asked us some other questions about our jobs and how much rent we paid. He told us he would get back in touch with us.

About a week later, we had another meeting with Mr. Sandow. He showed us a contract that had no address, and told us that if we signed it he could get the ball rolling. We signed the contract. The price on the contract was $119,000, but Mr. Sandow told us that it was just a rough draft. This is the price we paid for the house. I have recently learned that Easy Life purchased the house for $14,000 in May1995.

He showed us some pictures of homes, and then he took us to see some of them. They were in terrible neighborhoods, surrounded by abandoned houses. We told him that we didn't like the areas these houses were in, and that we wanted to buy a home on the north side so that it would be close to my day care clients. Mr. Sandow told us that Easy Life didn't have any homes for sale on the north side, but asked if we were interested in a home in Oak Park. I thought that my clients would come to Oak Park, a suburb just west of Chicago, so we said yes.

Mr. Sandow drove us to the house he said was in Oak Park. It was visibly fire-damaged and had been abandoned for some time. It was completely gutted, and was under construction. Mr. Sandow told us many parts of the house were too unsafe for us to see, but it looked large, and we thought it would work well for us and for my day care business. When I pointed out to him the crumbling walk way, the holes in the foundation, and the unstable foundation supporting the back porch, he told us again that the house would be totally rehabbed and that everything would be new by the time we moved in. I explained to Mr. Sandow that the first floor would need to be modified to meet state licensing requirements for a day care business. He said that would be no problem. In fact, he even met with a state day care licensing representative to discuss the requirements for modifying the house. We were very excited and thought our dreams were coming true.

We saw the house again with Mr. Sandow in mid-July. On this visit, we saw the basement for the first time. My mom told Mr. Sandow that we would need another bedroom in the basement. He said it would be taken care of. On the second floor, we saw that the stairs were cut too steep going up into the third floor, and that the ceiling on the third floor was very low. I asked Mr. Sandow if they could change the ceiling so we could use the third floor for bedrooms. I also asked him to fix the stairs so that they wouldn't be such a hazard. He said it would be no problem.

After that, I tried to go back and see the house several times, but the house sitter who was staying there would not let me in. Other times the workmen wouldn't let us in. When we asked Mr. Sandow about it, he told us everything was coming along fine and not to worry.

About a month before the closing, we found out from a family friend familiar with the west side that the house was not in Oak Park as Mr. Sandow had told us. Instead, the house was located in the Austin neighborhood of Chicago. My mother and I were very upset, and confronted Mr. Sandow. He admitted that the house was not in Oak Park, but told us that it was too late for us to back out now.

Before the closing, Mr. Sandow told us that he had found a company that was willing to give us a loan. We met with a gentleman from Dependable Mortgage at Easy Life's office. He told us that all we had to do was fill out some paperwork and everything would be fine. Neither he nor anybody else explained to us that we would have an adjustable rate mortgage. In fact, at the time, we did not know what an adjustable rate mortgage was, and had no idea that our mortgage could increase.

Also, before the closing, my mom asked Mr. Sandow if we needed to do anything else. Mr. Sandow told her that, as part of this special government program, Easy Life would supply a lawyer to represent us, conduct a home inspection for us, and have termite control specialist examine the house. At the closing in September 1995, the Easy Life lawyer gave us a lot of papers to sign, but he didn't explain anything about them. He seemed to be in a hurry, and said he had a boat to catch. We didn't understand everything we were signing, but we trusted the lawyer and signed the papers anyway.

We moved into the house about one week later. I noticed right away that Easy Life had not done the work required for my day care license. When I called Mr. Sandow to complain, he said, "Don't worry, go ahead and move in and we'll work around you." I kept calling and calling Mr. Sandow, but the modifications were never made and I was never able to get my license.

We soon began noticing other problems with the house. As you can see from these photographs, the house has a dangerous furnace which has resulted in numerous instances of overheating and burnouts of the gas regulator, a narrow and dangerous stairway to the basement, an overloaded and leaky roof with three or more layers, a garage that is leaning severely and is not usable, a damaged ceiling in the first floor bedroom from a constantly leaking toilet, a second floor deck that is improperly nailed through the roof, and poor ceramic tile work that has come loose. Underneath the cheap carpets Easy Life installed were the same burnt wooden floors I had seen when I first looked at the house. In addition, the walkways that Mr. Sandow had promised to repair were crumbling, and the foundation under the back porch was still unstable. The floors in some areas of the house didn't meet the walls, which allowed rain and snow to enter the house. The light sockets sparked and the toilets overflowed.

I complained about ten different times to Easy Life about problems in the house. In response, Easy Life sent some workmen to the house on several occasions. They did some caulking, nailed down the front steps, put a patch on the second floor toilet, and installed a ventilation system in the attic. But, the work they did lasted only for a day or two, and then the problems would come right back.

We've had many other problems with the house since we moved in. The representatives from the gas company have come to the house several times because of leaks in the furnace. They had to disconnect the gas and the piping, which they told us was old and not properly attached. They also told us that the furnace is unsafe. We have seen termites swarming, the plumbing leaks, and the garage is leaning heavily to one side. The windows were improperly installed, and there is no insulation. Instead, as you can see from the photograph, cheap new siding was installed over the burned wooden exterior, so cold air comes right through into the house in the winter.

My mother and I have tried our best to make the repairs we can, but we cannot afford to put the kind of money into the house that it needs to make everything right. I estimate that we have spent several thousand dollars of our own money to keep the house from falling apart. We have not been able to keep up with our mortgage payments because they kept going up. Right now, there is a foreclosure case pending against us, and we are afraid of losing our home.

I appreciate having the opportunity to tell my story here today. I will be glad to answer any questions the Subcommittee has. Thank you.

United States General Accounting Office

GAO

Testimony

Before the Permanent Subcommittee on Investigations, Committee on Governmental Affairs, U.S. Senate

For Release on Delivery
Expected at
9:30 a.m., EDT
Thursday
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# SINGLE-FAMILY HOUSING

# Stronger Oversight of FHA Lenders Could Reduce HUD's Insurance Risk

Statement of Stanley J. Czerwinski, Associate Director,
Housing and Community Development Issues,
Resources, Community, and Economic Development Division

GAO
Accountability * Integrity * Reliability

GAO/T-RCED-00-213

Madame Chairman and Members of the Subcommittee:

We are here to discuss our report that you requested and are releasing today on the Department of Housing and Urban Development's (HUD) oversight of lenders that make mortgage loans insured by HUD's Federal Housing Administration (FHA).[1] During fiscal year 1999 alone, FHA insured 1.3 million mortgages valued at about $124 billion. While FHA insures lenders against nearly all losses resulting from foreclosed loans, it relies on the lenders to underwrite the loans and determine their eligibility for FHA mortgage insurance.

Our review focused on the adequacy of HUD's policies and procedures for overseeing lenders. We performed limited tests and analyses to determine whether these policies and procedures were properly utilized to limit HUD's insurance risk.

In summary, our work revealed a number of weaknesses in the lender approval, monitoring, and enforcement efforts performed by HUD's headquarters and its four homeownership centers.[2]

- HUD's process for granting FHA-approved lenders direct endorsement authority—that is, the ability to underwrite loans and determine their eligibility for FHA mortgage insurance without HUD's prior review—provides only limited assurance that lenders receiving this authority are qualified.

- In addition, while HUD's homeownership centers have monitored lenders' compliance with FHA's lending requirements, these monitoring efforts have not adequately focused on the lenders and loans that pose the greatest insurance risks to the Department.

[1]*Single-Family Housing: Stronger Oversight of FHA Lenders Could Reduce HUD's Insurance Risk* (GAO/RCED-00-112, Apr. 28, 2000).

[2]HUD's four homeownership centers administer the single-family housing functions in the 50 states, the District of Columbia, and Puerto Rico. The centers are located in Atlanta, Georgia; Denver, Colorado; Philadelphia, Pennsylvania, and Santa Ana, California.

- Finally, although HUD has taken enforcement actions against lenders with excessively high default rates, it needs to take further steps to hold lenders accountable for poor performance and program violations.

Our report makes recommendations designed to improve HUD's processes for approving lenders to underwrite FHA-insured mortgages, for targeting lenders and loans for quality control reviews, and for taking enforcement actions against poorly performing lenders. In commenting on the report, HUD stated that it generally agreed with the report's recommendations.

**Background**

A homebuyer seeking a FHA-insured mortgage must submit a mortgage application to a FHA-approved lender. Once the lender approves the loan, it sends the loan documents to HUD for approval of FHA mortgage insurance. If the borrower defaults and the lender subsequently forecloses on the loan, the lender can file an insurance claim with HUD for the unpaid balance of the loan. As of December 1999, about 10,000 lending institutions were approved to participate in FHA's mortgage insurance programs for single-family homes.

Most FHA-approved lenders are authorized to originate FHA-insured loans, meaning that they can accept mortgage applications, obtain employment verifications and credit histories on applicants, order property appraisals, and perform other tasks that precede the loan underwriting process. Approximately 2,900 of the FHA-approved lending institutions also have direct endorsement authority, meaning that they can underwrite loans and determine their eligibility for FHA mortgage insurance without HUD's prior review. Underwriting refers to a risk analysis that uses information collected during the origination process to decide whether to approve a loan. Direct endorsement lenders may underwrite loans that either they originated or were originated by other lenders. Lenders with direct endorsement authority underwrite virtually all FHA-insured mortgages for single-family homes.

**Direct Endorsement Approval Process Provides Limited Assurance That Lenders Are Qualified**

HUD's process for granting FHA-approved lenders direct endorsement authority--the ability to underwrite loans and determine their eligibility for FHA mortgage insurance without HUD's prior review—provides only limited assurance that lenders receiving this authority are qualified. HUD's guidance does not adequately define the level of proficiency that lenders must achieve in order to be granted direct endorsement authority. As a result, HUD's homeownership centers have applied the guidance differently and have approved lenders that made multiple and serious underwriting errors.

FHA-approved lenders seeking direct endorsement authority go through a probationary period during which they are required to demonstrate acceptable performance in underwriting at least 15 mortgage loans. The mortgages are submitted to and evaluated by HUD's homeownership centers before the mortgages are finalized. These evaluations rate as "good," "fair," or "poor" various aspects of the lender's work, including its analysis of the credit risk posed by the borrower and the quality of the property appraisal. A "poor" rating indicates that the lender made underwriting errors that significantly increased HUD's insurance risk.

While HUD's guidance requires that lenders seeking direct endorsement authority demonstrate overall acceptable performance on these evaluations, the guidance is unclear on what constitutes "acceptable performance." As a result, HUD's homeownership centers have interpreted the guidance differently. For example, the Denver center interpreted the guidance to mean that lenders had to submit 15 mortgages for which they received at least "good" or "fair" ratings. In contrast, the Santa Ana center did not have a requirement for the number of "good" and "fair" ratings that lenders had to achieve.

HUD's four homeownership centers granted direct endorsement authority to a total of 36 lenders during the 6 months prior to our 1999 visits to the centers. We reviewed the ratings that each of these lenders received from the centers for the lender's evaluation of the credit risk posed by the borrower. Our analysis showed significant variations in what HUD's homeownership centers considered as acceptable performance, reflecting the vagueness and inconsistent application of HUD's approval standards. Overall, of the 36 lenders, 8 received no "poor" ratings for the last 15 mortgages they submitted to the centers for review. However, 12 lenders received "poor" ratings in over a quarter of their last 15 mortgages. The lenders' errors included their failure to (1) verify the borrower's employment and income, (2) ensure that the borrower had sufficient income to support the monthly mortgage payments, (3) explain delinquent accounts and collections on the borrower's credit reports, and (4) properly calculate the borrower's debts or liabilities. We believe that lenders such as these 12 may pose a high insurance risk to the Department once they begin underwriting and approving loans without HUD's prior reviews.

To improve HUD's process for granting lenders direct endorsement authority, our report recommended that HUD develop specific performance standards for lenders seeking this authority.

**Monitoring Process Does Not Adequately Focus on Riskiest Lenders and Loans**

HUD's homeownership centers use two monitoring tools to ensure lenders' compliance with FHA's lending requirements: (1) on-site evaluations of lenders' operations, known as *lender reviews,* and (2) desk audits of the underwriting quality of loans already insured by FHA, known as *technical reviews.* HUD's guidance stresses the importance of using risk analysis to allocate a larger share of monitoring resources to program activities that pose the highest risks to the Department. However, the homeownership centers have not adequately focused their monitoring efforts on lenders and loans that pose the highest insurance risks.

<u>HUD Has Reviewed More Lenders in Recent Years but Often Not the Riskiest Ones</u>

In recent years, HUD has placed greater emphasis on performing on-site evaluations of lenders' operations. For example, the number of lender reviews that HUD performed grew from 291 in fiscal year 1996 to 932 to in fiscal year 1999. HUD's guidance states that 85 percent of the lender reviews should be targeted at high-risk lenders. However, we found that the homeownership centers often did not review the lenders that they considered to pose the highest risks. For example, the Philadelphia center developed a list of 131 high-risk lenders that it considered to be a high priority for review in fiscal year 1999. Despite conducting reviews of 228 lenders during fiscal year 1999, the center reviewed just 39–or about 30 percent–of the 131 lenders on its priority list. While the other homeownership centers did not have similar priority lists, center officials told us that they frequently selected for review those lenders that did not pose a high insurance risk to HUD. For instance, a Santa Ana center official estimated that half of the reviews the center performed in fiscal year 1999 were of lenders that had few or no early defaults—that is, loans that defaulted within 24 months. Because loans that default this quickly are an indicator of poor lending practices that may result in insurance losses, HUD considers them to be an important factor in assessing lenders' risk.

Homeownership center officials cited inexperienced staff and limited or uncertain travel funds as reasons why high-risk lenders were not always reviewed. For instance, according to the four homeownership centers, most of the centers' 140 staff who conduct lender reviews assumed their current positions in fiscal years 1998 and 1999–largely from the pool of HUD field staff who remained unassigned after HUD's 1998 reorganization. Center officials also told us that they generally did not allow staff with less than a year of experience to review high-risk lenders because their inexperience might lead them to overlook serious deficiencies.

Furthermore, although HUD's guidance states that lenders should be rated and prioritized for review, the Department has not developed a systematic process for doing so. HUD's guidance lists several risk factors that should be considered in targeting lenders for reviews, including default rates, the late payment of mortgage insurance premiums to HUD, and the volume of business. But the guidance indicates neither how these factors should be weighted nor how lenders should be prioritized. As a result, the centers have not targeted lenders for reviews in a consistent manner. To more effectively monitor lenders' performance, our report recommends that HUD develop procedures to identify and prioritize high-risk lenders for lender reviews and ensure that the homeownership centers consistently apply these procedures.

Selection of Loans for Technical Reviews Was Not Based on Risk

Technical reviews–desk audits that evaluate the underwriting quality of loans already insured by FHA–are another tool that HUD uses to monitor the performance of lenders. If technical reviews reveal serious deficiencies, HUD may suspend the lenders' authority to underwrite FHA-insured loans, among other things.

All four of HUD's homeownership centers met the Department's goal to perform technical reviews on no less than 10 percent of the FHA-insured mortgage loans made during fiscal year 1999. However, the centers have not effectively implemented HUD's guidance, which states that technical reviews should be targeted at loans that exhibit high-risk characteristics, such as loans to borrowers with unusually high expenses relative to their income. Instead, HUD's homeownership centers rely primarily on a random process for selecting loans for technical reviews. The computer system that supports HUD staff in processing mortgage insurance randomly selects a certain percentage of each lender's loans for technical reviews. However, the system cannot automatically identify and select for review those loans that exhibit high-risk characteristics. HUD's four homeownership centers told us that they sometimes manually selected high-risk loans for reviews but that the large volume of loans that they processed for FHA insurance, coupled with staffing constraints, made it impractical to do this on a routine basis. To address this problem, our report recommends that HUD enhance its management information systems to identify and select, for technical reviews, loans that pose a high insurance risk to the Department.

**Efforts to Hold Lenders Accountable for Poor Performance Have Not Been Sufficient**

To hold lenders accountable for program violations or poor performance, HUD may, among other things, (1) suspend their direct endorsement authority and (2) terminate their loan origination authority through its Credit Watch program, which is designed to hold lenders accountable for excessive defaults and insurance claims on FHA-insured mortgages. However, the homeownership centers have made only limited use of their ability to suspend lenders' direct endorsement authority. Furthermore, certain lenders have escaped accountability under the Credit Watch program.

Homeownership Centers Made Limited Use of Their Ability to Suspend Lenders' Direct Endorsement Authority

HUD's guidance allows the homeownership centers to suspend the direct endorsement authority of lenders that fail to comply with FHA's program requirements but provides only general guidelines for determining which lenders should be subject to this action. Lenders whose direct endorsement authority is suspended must submit their mortgage case files to the homeownership centers, which evaluate the lenders' underwriting decisions before deciding whether to insure the loans.

Among the four homeownership centers, we found that the Philadelphia center was the only one that had suspended the direct endorsement authority of any lenders during fiscal year 1999. Specifically, the Philadelphia center took this action against eight lenders in fiscal year 1999, citing underwriting violations identified by technical reviews or lender reviews. Although the centers suspended relatively few lenders, our analysis of HUD's technical review ratings for fiscal year 1999 showed frequent noncompliance with FHA's underwriting requirements, indicating that many lenders may be candidates for this action. Specifically, we identified 206 lenders nationwide that, during fiscal year 1999, received "poor" ratings on more than 30 percent of their reviewed loans for their evaluation of the credit risk posed by the borrower.[3] A "poor" rating means that the lender made mistakes that significantly increased HUD's insurance risk. Of these 206 lenders, 131 made 10 or more FHA-insured loans in fiscal year 1999. HUD's guidance does not specify the extent of noncompliance with FHA's requirements that would warrant the suspension of a lender's direct endorsement authority. However, in our opinion, the extent of noncompliance demonstrated by these 131 lenders indicates that they may be candidates for this action. As of October 1, 1999, HUD's homeownership centers had not suspended any of these lenders.

To strengthen HUD's enforcement efforts against lenders, our report recommends that HUD clarify and implement guidelines for identifying lenders whose direct endorsement authority should be suspended.

Lenders Underwriting Loans Originated by Others Escape Responsibility for Excessive Default and Claim Rates Under HUD's Credit Watch Program

In May 1999, HUD announced that it would begin to use its Credit Watch program to sanction lenders with excessive defaults and insurance claims on FHA-insured mortgages. HUD planned to terminate the loan origination authority of any lender whose default and claim rates on mortgages insured by FHA during the preceding 24 months exceeded both the national average and 300 percent of the average rate for the HUD field office serving the lender's geographic location. Similarly, HUD planned to place on "credit watch" status the lenders whose default and claim rates exceeded both the national average and 200 percent of the corresponding HUD field office average. While on "credit watch" status, the lender can continue to originate FHA-insured loans, but its performance receives greater scrutiny from HUD.

[3]The 206 lenders were among the approximately 5,000 lenders that received technical review ratings in fiscal year 1999 for mortgages they both originated and underwrote.

As of April 2000, HUD had completed four rounds of its Credit Watch program. This program has resulted in the Department's actual or proposed termination of 64 lenders' loan origination authority and the placement of 140 additional lenders on "credit watch" status.

The regulations governing HUD's Credit Watch program allow the Department to hold accountable for excessive defaults or insurance claims the lenders that originated the troubled loans. However, the regulations do not address HUD's authority to also hold accountable those lenders that underwrote the loans. When originating mortgage loans, lenders perform such functions as accepting mortgage applications and obtaining employment verifications and credit reports on the borrowers. When underwriting mortgage loans, lenders use this information to determine whether borrowers are able to make their mortgage payments and whether the loans should be approved. HUD officials told us they recognized that the underwriting lenders contributed to excessive defaults and insurance claims but that the Credit Watch program's regulations did not permit them to take enforcement actions against these lenders. The officials said they were considering regulatory changes to address this problem.

The results of the first round of the Credit Watch program illustrate the program's limitations as an enforcement tool. Of the 33 lenders that HUD terminated during the first round of the program, 17 relied on other lenders to underwrite the nearly 6,200 loans that they originated and FHA insured during the 24-month period of analysis. Nevertheless, the underwriting lenders escaped sanctions under the Credit Watch program.

The Credit Watch program is also facing a legal challenge. In September 1999, one lender whose authority to originate FHA-insured mortgage loans was terminated by HUD filed a lawsuit seeking to overturn HUD's actions. Among other issues, the lender contended that HUD had exceeded its statutory authority when it issued its Credit Watch regulations and that the manner in which HUD terminated the lender's authority had deprived the lender of due process. In October 1999, a federal district court ruled that HUD's Credit Watch regulations were invalid and set aside HUD's termination of the lender. The court stated that HUD's statutory authority requires that after determining that a lender has excessive defaults and claims, HUD must provide the lender with the opportunity to provide the Department with a plan and timetable for correcting the defaults. The court stated that HUD had sidestepped its statutory mandate by enacting regulations that allowed the Department to terminate a lender's authority to originate loans whenever HUD deemed it appropriate because of the lender's default and claim rates. The court also concluded that even if HUD had the authority to issue such regulations, the regulations denied the lender its right to due process. HUD has appealed the court's decision. In May 2000, another lender successfully sought a court injunction that prevented HUD from terminating this lender's authority to originate FHA-insured mortgages. Our report recommends that once the legal basis of the Credit Watch program is resolved, HUD revise the program's regulations to cover lenders that underwrite FHA-insured loans with excessive defaults and claims rates as well as those lenders that originate such loans.

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Madame Chairman, this concludes our testimony. We would be happy to answer any questions that you or members of the Subcommittee may have.

**Contact and Acknowledgement**

For further information regarding this testimony, please contact Stanley J. Czerwinski at (202) 512-7631. Individuals making key contributions to this testimony included Karen Bracey, Karin Lennon, Stan Ritchick, Paul Schmidt, Steve Westley, and Shana Whitehead.

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**STATEMENT BEFORE THE SENATE COMMITTEE ON GOVERNMENT AFFAIRS PERMANENT SUBCOMMITTEE ON INVESTIGATIONS**

**JUNE 30, 2000**
**WASHINGTON, DC**

**BY**

**WILLIAM APGAR**
**ASSISTANT SECRETARY FOR HOUSING/FEDERAL HOUSING COMMISSIONER**

**TESTIMONY OF ASSISTANT SECRETARY FOR HOUSING
FEDERAL HOUSING COMMISSIONER WILLIAM APGAR
PERMANENT SUBCOMMITTEE ON INVESTIGATIONS
U.S. SENATE**

Good Morning Chairman Collins and members of the Subcommittee. My name is William Apgar, and I am the Assistant Secretary for Housing/Federal Housing Commissioner at the United States Department of Housing and Urban Development (HUD). On behalf of HUD Secretary Andrew Cuomo, I want to thank you for the opportunity to testify today on HUD's efforts to protect FHA borrowers from abusive mortgage practices.

As you know, more than three years ago Secretary Cuomo declared that HUD would have no tolerance for waste, fraud and abuse. At the core of HUD's 2020 management reforms are efforts to develop new technologies and new approaches to identify and to deal with a type of abuse of the FHA system known more generally as predatory lending practices. Today, HUD and the FHA are recognized leaders in what is now a national effort to crack down on predatory practices in all markets, including the emerging sub-prime market, and the existing conventional and government insured markets. Just last week, Secretary Cuomo joined with Treasury Secretary Lawrence Summers to release a comprehensive report on how best to stem predatory lending, particularly in the subprime market, while in May Secretary Cuomo joined Senators Barbara Mikulski and Paul Sarbanes in announcing a new set of initiatives to provide relief to victims of predatory lending linked to FHA insured loans.

Today's hearing focuses on abusive practices aimed at FHA borrowers. Therefore I would like to describe to you the aggressive measures we have put in place over the past three years to protect FHA borrowers and hold FHA business partners accountable for their actions. I also understand that you heard testimony yesterday from several fraud victims, suggesting that our work is not done. One victim, is one too many, so in addition to detailing what we have already done, I will also lay out a series of legislative efforts that will enable FHA to expand its enforcement efforts, and promote consumers education and counseling. In addition, I will briefly describe a series of proposal that address predatory practices by some subprime lenders. Predatory lending is a serious issue, and Congress has the opportunity to join with HUD and the Administration in taking serious action to stem abusive practices where ever they may occur. I hope this hearing will serve as a catalyst for such action.

**THE FHA's RECORD OF SERVICE**

In April of this year, the nation's homeownership rate reached a record high with 67.1% of American families owning their own homes. This meant that a total of 70.7 million families owned their homes, an increase of 8.3 million since 1993. In addition to the overall increase, record high levels of homeownership were also recorded for central city residents, as well as among African American and Hispanic families.

FHA has played a key role in helping families realize the dream of homeownership. Since 1934, FHA has helped nearly 30 million American families to become homeowners. We do this by insuring home mortgages, providing valuable credit enhancement that encourages private lenders to make home loans they otherwise would deem too risky. Last year alone, FHA insured 1.3 million loans with an all time record value of $125 billion. Perhaps most importantly, FHA provides this valuable service to the American homebuying public at no cost to the taxpayer. The insurance premiums we collect plus recoveries on properties sold from the real estate owned (REO) inventory exceed the cost of all claims and operations. Indeed, over the next five years, FHA is projected to contribute nearly 20 billion dollars to the national budget surplus.

**FHA IS THE STRONGEST IT HAS EVER BEEN**

Under the leadership of Secretary Andrew Cuomo, HUD has been working hard to reform the Department and the FHA. Nowhere is the turnaround more evident that in the FHA's mortgage insurance programs. Despite a six-decade history of providing access to mortgage capital – in all regions of the country – in good times and bad – by the early 1990s the FHA was broke. Years of mismanagement left the FHA with projected losses from claims on mortgage insurance far in excess of projected revenue. Absent radical restructuring, a costly federal bailout seemed inevitable.

Yet today, the FHA and its Mutual Mortgage Insurance (MMI) Fund are the healthiest they have been in decades. The most recent actuarial study -- prepared by Deloitte & Touche – provides detailed information on the financial status of the MMI Fund for the fiscal year ending September 30, 1999, and presents projections of the Fund's performance over the next five years. The Deloitte & Touche review focuses on two key measures of the health of the fund: First, the economic value of the MMI fund – defined as the sum of existing capital plus the value of current books of business – and second, the FHA's capital adequacy ratio – defined as the economic value of the fund divided by the total unamortized insurance in force. In specific, the report shows:

- At the end of FY99, the economic value of the fund was an all time record high of $16.637 billion, an increase of $5.277 billion from the economic value as reported for FY98; and,
- Also for FY99, the capital adequacy ratio stood at 3.66 percent, a dramatic increase over the FY98 capital ration of 2.71 percent, and well in excess of the Congressional mandate to exceed a benchmark ratio of 2.00 percent by the year 2000.

As these data indicate, this is a remarkable turnaround from just ten years ago, when the FHA MMI fund had an economic value of negative $2.7 billion. The Deloitte & Touche study also confirms that this improvement is due to fundamental changes in the FHA, including improved underwriting of loans, expanded lender and appraisal monitoring, more effective use of loss mitigation, and streamlined procedures for sale of foreclosed properties. As a result of this progress, the Deloitte & Touche study report projects that the FHA is sufficiently well capitalized to withstand future economic downturns. Deloitte & Touche estimate that:

- Under the most likely economic scenario which is a continued stable and strong performance, the FHA capital ratio continues to rise steadily to 5.29 percent in 2006; and,

- Even under pessimistic assumptions, the capital ratio continues to rise – if some what slower – to 3.90 percent in 2006.

**FHA SERVES ITS SOCIAL MISSION BETTER THAN EVER**

While the Actuarial report is good news in and of itself, I am equally pleased to report that the FHA has been able to dramatically improve its financial bottom line, while simultaneously improving its record of service to first-time homebuyers, minorities, and others not well served by convention market:

- In FY 99, 80.8 percent of FHA purchase money loans went to first time buyers, compared with 64.4 percent in FY92.

- Minority borrowers also increased as a share of FHA homebuyers to 37.7 percent in FY99 compared with 21.7 percent in FY92.

I am particularly proud of FHA's record of serving African-American and Hispanic- American families:

- In FY99, FHA guaranteed an all time record 170,193 African-American families, a more than three fold increase over the number served in FY92

- For Hispanics, the numbers are even more impressive – the record 222,822 loans guaranteed for Hispanic borrowers in FY99 represents a four fold increase over FY92 levels.

**FHA REFORMS ARE WORKING**

The health of the fund and the solid record expanding access to homeownership are dramatic evidence that HUD works. Secretary Cuomo's Management Reform plan has brought to HUD new ways of doing buisness, new technology, and new capacity to address the housing and community development needs of the nation's low and moderate income families and communities. Over the past three years, the FHA has initiated a comprehensive approach to protect FHA borrowers from predatory lending practices.

*a. Lender Monitoring and Enforcement*

Over the last three years, HUD has taken a number of steps to more clearly hold its lender partners accountable for their actions. Although the vast majority of our lender partners act responsibly, FHA recognizes that even a small handful of irresponsible lenders can cause tremendous harm to individual borrowers, and ultimately create losses for the FHA insurance fund. Therefore, HUD has instituted a number of initiatives designed to enhance FHA's lender enforcement activities, including:

- **Credit Watch, a new performance-based lender monitoring and enforcement system:** Under this system, launched in May, 1999, FHA reviews all participating lenders' loan default and claim rates by geographic area on a quarterly basis, and immediately moves to terminate those with the most egregiously high default and claims rates. In the first year of operation, FHA has terminated 48 lenders, proposed termination of another 10 lenders and placed another approximately 135 lenders on probationary lending status;

- **Enhanced lender monitoring activities:** Over the past three years, FHA has increased its lender monitoring staff more than sevenfold, from just 23 monitors in 1997, to more than 140 today. Similarly, FHA has dramatically increased the number of lender monitoring reviews from just 256 in FY1997, to more than 900 in FY1999;

- **Stepped-up lender enforcement actions:** The investment in increased monitoring is beginning to pay off in the form of more lender enforcement actions. HUD's Mortgagee Review Board (MRB) imposed more than $1.7 million in civil money penalties on more than 30 lenders last year, and received indemnifications on a total of 1,025 loans, saving the Department an estimated $32 million in avoided losses – nearly as many indemnifications as the Department required over the preceding two years.

*b. FHA's Appraisal Reform Initiative*

Property flipping -- the primary focus of this subcommittee -- is most often associated with inflated or fraudulent appraisals. Therefore, our initiatives to safeguard the Fund began with the reform of the Federal Housing Administration's (FHA) appraisal process. Under the Homebuyer Protection Plan, FHA has developed the most comprehensive and thorough appraisal procedures in the housing finance marketplace today. Our reform package, which was developed during 1998 working in partnership with the Mortgage Bankers Association, the National Association of Realtors, the Appraisal Institute, the Appraisal Foundation and several consumer advocacy groups, is intended to provide the consumer with an unprecedented amount of information about the physical condition of the home they are purchasing, and also to create a more effective framework for FHA to hold appraisers accountable for their work. The initiative includes the following features:

- **Mandatory appraiser testing**: For the first time ever, all FHA appraisers now are required to pass an exam testing their knowledge of FHA appraisal requirements. This requirement was implemented on July 1, 1999, and is a mandatory requirement as of February 1, 2000;

- **A new, more thorough Valuation Condition (VC) form required for every FHA appraisal**: FHA is now the only mortgage finance organization in the country that requires every appraisal to include completion of a four page form that captures comprehensive information regarding the physical condition of the property. This form was made mandatory in all FHA appraisals as of September 13, 1999;

- **Homebuyer Summary Form**: FHA also is requiring lenders to provide every borrower with a summary of the results of the Valuation Condition form. This summary highlights any property physical conditions that do not meet HUD minimum property standards. This form also was made a mandatory component of all FHA appraisals as of September 13, 1999;

- **New Homebuyer Protection Form**: FHA now requires lenders to provide all borrowers this notice highlighting the importance of getting a home inspection. Implemented on September 13, 1999;

- **Enhanced appraiser enforcement processes and authority**: Working with the consulting firm Arthur Andersen, FHA also has developed a new method of using statistical indicators to target poor performing appraisers for extra monitoring activity. As part of this initiative, FHA also issued a new proposed federal regulation to clarify existing authority to pursue enforcement sanctions against fraudulent and poor performing appraisers in March, 2000.

Taken together, these reforms create the most effective safeguards against mortgage fraud – a well informed consumer and a clear and deliberate process for monitoring appraisers' work and pursing enforcement actions when warranted.

*c. Aggressive Foreclosure Avoidance*

In 1996 Congress authorized and FHA implemented a comprehensive new program of foreclosure avoidance, or loan loss mitigation, that protects the interest of borrowers and the financial integrity of the FHA Fund. This new program replaced the ineffective Assignment Program, which often left borrowers deeper in debt and was costly to the Fund. FHA's program includes a new comprehensive set of loan loss mitigation tools -- special forbearance periods, modification of loan payments, balance and/or interest rate, as well as pre-foreclosure sales to try to help borrowers in default avoid foreclosure and maintain ownership of their home. This broader set of tools addresses a far greater range of borrower problems than could be addressed through the Assignment Program. Perhaps most importantly, the Loss Mitigation Program shifts the emphasis to early intervention in the default cycle, when there is the greatest potential for the borrower to recover from default and remain in their home.

Through a combination of aggressive outreach and training for servicers, and tough monitoring and enforcement actions when necessary, FHA has grown this program substantially over the last three years. After assisting just approximately 5,800 borrowers in default in the first year of the program FY 1997, FHA assisted nearly 10,800 borrowers in FY 1998 and then more than doubled the program one year later when it helped nearly 27,000 borrowers in FY1999 avoid foreclosure. Moreover, more than 80 percent of all loss mitigation actions last year helped the borrower not only avoid foreclosure, but also maintain ownership of their home through a special forbearance, mortgage modification or a partial payment of claim. So far this year, FHA has helped nearly 23,000 borrowers in default avoid foreclosure and keep their homes – a pace that should result in more than 32,000 actions by the end of the fiscal year.

**FHA FRAUD PREVENTION PLAN: PROTECTING FHA HOMEOWNERS FROM PREDATORY LENDING**

Building on these successful initiatives, in May FHA announced a series of initiatives to provide relief to those FHA borrowers already in distress, especially those who have been victimized by abusive lending practices and to intensively focus enforcement activities in areas with an unusually high number of foreclosures, so called "hot zones." Specific initiatives include:

**Counseling Borrowers in Default.** HUD's network of more than 1,200 approved counseling agencies nationwide help thousands of families every year make well-informed home purchase decisions. But due to insufficient Congressional funding for HUD certified counseling agencies, the availability of counseling services is uneven across geographic areas, and there are far too few agencies with the capacity to provide specialized foreclosure avoidance counseling to borrowers in default. Therefore, FHA is launching a new initiative to directly fund default counseling in select "Hot Zones". Through this program, FHA will offer borrowers in default a voucher for counseling services, redeemable at their local HUD-approved counseling agency. Once completed, the counseling provider agency can redeem the voucher with HUD to receive payment. As an eligible effort under the loss mitigation, this initiative will be funded from FHA's mortgage insurance fund.

**Restructuring Inflated Mortgages.** Once FHA identifies a mortgage based on a fraudulent appraisal, FHA will move to force the lender to write the mortgage down to a level consistent with true market value. In the case of a recalcitrant lender, FHA loss mitigation specialists will intervene directly, cancel the insurance, take possession of the deed, and resell the property with FHA insurance to the family for the fair market price.

**Repairing Credit of Abused Borrowers.** In cases of default or foreclosure linked to fraudulent appraisals or underwriting, FHA will instruct the lender to issue a "credit repair letter" to the borrower and notify the credit reporting agencies of this action.

**Approving New Software to Empower Default Counselors.** Working in cooperation with national vendors, FHA has developed guidance on new computer software which assists default counselors in examining FHA foreclosure avoidance options and advising clients as to the best course of action. The first software package approved for use under this new initiative, "BackInTheBlack" loss mitigation application, was developed by a Baltimore based company, and is available free of charge to local housing counseling agencies. FHA is also currently reviewing additional software programs at the request of other developers. FHA is pleased to participate in the development of these foreclosure avoidance software packages which, when used properly, promote effective early response and appropriate use of FHA's foreclosure avoidance actions.

**Focusing Resources on Loss Mitigation Assistance.** In "Hot Zone" areas with high default and foreclosure rates, FHA will establish teams of loss mitigation specialists to work with lenders and borrowers to ensure that every effort is made to help families remain in their homes.

**Using "SWAT" Teams to Identify Unscrupulous Appraisers and Predatory Lenders in Hot Zones.** In Baltimore, FHA sent a SWAT team to review all initial petitions to foreclose taking place from January through March of 2000. Based on this review, FHA identified a number of apparently fraudulent practices on the part of FHA appraisers and lenders. These individuals and firms will be referred to FHA's Quality Assurance Division for further action, and if appropriate, to HUD's Enforcement Center or Office of Inspector General. By immediately stopping such bad actors in their tracks, communities can begin to recover. HUD plans to immediately extend the SWAT team approach to assess potential fraudulent activities in other cities now experiencing high numbers of FHA defaults and foreclosure

## HUD's LEGISLATIVE AGENDA

Over the past three years, HUD has taken aggressive action to stem waste, fraud and abuse in FHA programs, as well as the broader mortgage market. To build on these efforts, Congress should move quickly to enact legislation to protect consumers from predatory practices. In particular, Congress should:

**Support Legislative Initiatives Presented in the HUD/Treasury Report**
A comprehensive assault on predatory practices must focus on the growing abuses in the subprime market. In their recent report on the topic, HUD and Treasury outlined a series of legislative initiatives targeted to protecting consumers from these abusive practices. These recommendations closely parallel the legislative proposals already introduced by Senators Sarbanes and Schumer, and Representatives LaFalce and Schakowsky. Congress should work to resolve the differences remaining among these proposals and enact comprehensive legislation this year to protect consumers from predatory practices

**Support Administration Requests to Fund Homebuyer Education** Homeownership education and counseling is widely recognized as one of the best ways to help consumers avoid becoming victims of predatory practices. Despite this, last year, Congress cut

HUD's counseling budget. Even more dramatic cuts are contained in the appropriation bill just passed by the House. Congress should fully fund the $24 million Administration request to fund these vital consumer education and counseling services.

**Credit Watch Termination Codification**: The National Housing Act requires HUD to operate the FHA Mutual Mortgage Insurance Fund (which backs the majority of FHA-insured single family mortgages) in an actuarially sound manner. To accomplish this, FHA needs the ability to stop doing business quickly with a mortgagee whose high level of early defaults and claims presents an unacceptable risk to the insurance fund.

Just this week , Senators Mikulski and Sarbanes introduced legislation to amend section 533 of the National Housing Act to confirm the Department's existing authority to terminate the mortgagee approval when the mortgagee has an unacceptably high level of early defaults and claims for such mortgages in the area covered by a HUD field office, in comparison to other mortgagees lending in the same area. This would not affect a mortgagee's ability to continue to service, hold, or invest in FHA-insured mortgages.

FHA's termination regulation supplements, and performs a different purpose than, the regulations of the Mortgagee Review Board (MRB). The MRB is the only entity with authority to withdraw FHA approval from a mortgagee completely and, in essence, stop the mortgagee from doing any further business with FHA. The MRB takes this action if FHA proves that the mortgagee has engaged in fraudulent or other significantly deficient practices. This procedure does not address the situation of a demonstrably poor performer that has not engaged in provable violations or fraud.

If FHA is to operate in a more efficient and business-like manner, it needs to focus on outcome and performance, not process. Mortgagees whose loans perform so poorly that many default in their early months present a clearly unacceptable risk to the FHA insurance fund that, ultimately, may impair FHA's ability to continue to serve the low- and moderate-income borrowers who depend on FHA. FHA needs to continue to have a business mechanism to prevent these mortgagees from originating or underwriting new FHA-insured loans (and consequently from increasing the risks to the insurance funds and affecting FHA's ability to serve borrowers) without having to prove that the mortgagee is engaging in fraud or other irregularities. This proposed legislation would provide a more explicit statutory foundation for such a mechanism.

Despite the fact that FHA has clear, general statutory authority to administer the Credit Watch Termination program, two Baltimore area lenders have been successful in fighting proposed termination of their authority to originate FHA-insured loans in the Baltimore Federal District Court. HUD along with the Department of Justice (DOJ) is appealing both of these adverse decisions. To date, FHA has successfully terminated approximately fifty lenders trough the Credit Watch Termination program, with just these two Baltimore cases, brought by Capitol Mortgage and American Skycorp Mortgage, successfully fighting termination in court. Still, the Department seeks a legislative amendment to

Section 533 of the National Housing Act, to more clearly codify the Credit Watch Termination program into HUD's statutory authority. The proposed legislation would mitigate the likelihood of future successful litigation against the Department.

**CONCLUSION**

Under the leadership of Secretary Andrew Cuomo, HUD has a demonstrated track record of rooting out waste fraud and abuse. Predatory lending is a serious problem, and FHA has taken serious actions to hold our business partners to high standards of performance. There will always be some who will attempt to defraud the FHA and the millions of families that rely on the FHA to purchase their first home. For more than three years, FHA has aggressively expanded its fraud protection tool kit. The results are evident – FHA is in the soundest financial shape ever and well positioned to meet the future homebuying needs of the nation's low- and moderate-income families

STATEMENT OF
SUSAN GAFFNEY, INSPECTOR GENERAL
DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

BEFORE THE UNITED STATES SENATE PERMANENT
SUBCOMMITTEE ON INVESTIGATIONS
COMMITTEE ON GOVERNMENTAL AFFAIRS
JUNE 30, 2000

Madame Chairman and other members of the Subcommittee, it is my pleasure to testify before you today on the subject of property flipping in connection with FHA-insured mortgage transactions. Accompanying me today are Kathryn Kuhl-Inclan, Assistant Inspector General for Audit, and Philip A. Kesaris, Assistant Inspector General for Investigation.

The Department continues to point out that the FHA insurance fund is financially the healthiest it has been in many years. FHA continues to exceed its capital reserve requirements and FHA loan origination activity is growing. Much of this financial health is due to a robust economy, recent FHA actions to correct the problems associated with Adjustable Rate Mortgages, and a high mortgage insurance premium structure. Prior to 1983, the FHA Mortgage Insurance Premium was an annual charge of ½% of the outstanding mortgage principal balance. Today, FHA collects both up front and annual premiums. Most FHA loans include a 2.25% up front premium as well as an annual premium of ½% of the outstanding mortgage principal balance.

We are not here to debate the financial viability of the FHA Insurance Fund. That viability is based on an actuarial study supported by numerous assumptions about future economic performance. Those are economic factors we have little control over. We are instead here to discuss what we consider massive fraud in FHA loan origination activities. Just because the FHA fund is profitable is no reason to tolerate program fraud. The fraud we are finding harms the very people that the FHA program was designed to help. While the present health of the fund is important, its long term financial health is critical. FHA should take heed of the many warning indicators we are seeing in our audits and investigations. It is important to keep in mind that a troubled loan today may take several years before it results in an FHA claim.

## The Flipping Problem

Now let me turn to the phenomenon of property flipping. Buying a home at a low price and then reselling it at an inflated price within a short time frame, often after making only cosmetic improvements to the property, is in and of itself not illegal. It's no different than you and I making a few dollars on the stock market by buying low and selling high. In playing the market, we take a risk and sometimes it pays off with profits. But, we know there are laws to ensure that our stock profits are the result of arms length transactions and that our gains are not based on insider trading. What makes a property flip illegal is when there is something amiss in the transaction. When we see properties with FHA mortgage insurance bought and sold the same day for a 50% or a 100% profit, we can be reasonably certain that something is wrong. In most cases, the profit results from false and fraudulent documentation provided by one or more of the parties to the transaction, such as the lender and/or the appraiser. In almost every case where we've seen a property flip--i.e., a wide disparity between the purchase price and the resale price of a property, and a short turnaround between the two transactions-- something illegal has happened. Unfortunately, these flips feed on each other as the inflated value of one flipped property becomes the valuation measure for the next property and so on and so on. Before long, these transactions have a devastating effect on neighborhoods. I'm certain that for every property flip that results in a defaulted FHA loan, there are many others that go undetected as homeowners continue making payments on inflated mortgages.

Our audits and investigations have indicated that flipping is increasing and has become a major problem for many communities. What is similar about these communities is the high volume of older decaying properties and an eager group of potential, often unsophisticated, low-income buyers who are anxious to achieve the American Dream of home ownership. In many cases we find that the dream of home ownership turns into a nightmare as the property begins to need major repairs and the owner discovers that the property's real value is only a fraction of its original purchase price.

Let me provide you with a few examples of recent OIG criminal investigations involving property flipping:

- Last week in Fort Lauderdale, Florida, a Federal grand jury returned an 11 count indictment charging seven individuals with conspiracy to commit bank fraud, HUD fraud and false statements on more than 120 loan applications, most of them FHA-insured, totaling in excess of $15 million dollars. The mortgage fraud was predicated on a flipping scheme. A real estate investor would purchase homes and, on the same day, resell them at inflated prices to unqualified buyers he had recruited. The buyers of these properties--almost always unsophisticated, first time home buyers and/or recent immigrants--did not have sufficient income or assets to pay the required down payment and closing costs, so the investor would illegally provide funds to them and incorporate these costs into the price of the over-inflated loans. A variety of fraudulent documents were used to make it appear that the buyers qualified for the loans.

- In December 1999, 39 individuals were indicted in Los Angeles, California, for engaging in a $110 million dollar fraudulent loan scheme. To date, almost all of these individuals have pled guilty to wire fraud, money laundering, and HUD fraud charges. This case began with the identification of an individual who was a forger of loan documents who had kept diligent records over a 7-year period of creating false documents for inclusion in loan packages submitted to FHA for insurance. The investigation quickly uncovered a layer of investors and others involved in the real estate industry who were operating throughout the Los Angeles Basin using the forged documents in flipping schemes. Multiple properties were bought and quickly resold at inflated prices based on fraudulent appraisal values. Large loans were made based on the inflated appraisals, and sellers and those participating in the scam lined their pockets with the extra cash. At the press conference announcing the indictments, the United States Attorney said that "this type of fraud takes money from parents in need, those who dream of providing a house for their children, and puts it in the pockets of people who have been licensed as professionals but who really are just criminals–and greedy ones at that."

- In another case in Los Angeles, a mortgage broker pled guilty to conspiracy and loan fraud by obtaining false verifications of employment, income, and gift letters on behalf of alleged mortgagors for the purpose of obtaining FHA insured loans. He used strawbuyers to act as purchasers of the properties which were insured for over $1 million.

- In Baltimore, Maryland, a property speculator, two loan originators, an appraiser and a settlement attorney were indicted for engaging in a prolific scheme to acquire inexpensive homes and fraudulently qualify buyers to purchase the properties at much higher prices. The vast majority of over 100 settlement statements contained false information about the buyers' and sellers' monetary contributions to the transactions. Appraisals often overstated property values and misrepresented ownership at the time of the sale.

- In just one loan origination fraud investigation that is currently ongoing, we have identified over 1,200 FHA insured loans totaling over $160 million dollars; 25% of the loans, over $40 million dollars, have already resulted in defaults and many have resulted in claims to FHA. Common to all 1,200 of these loans: a small group of individuals who prepared fraudulent documents and provided false verifications of employment that were used in the origination of each loan. A total of approximately 100 individuals employed in various segments of the real estate and lending industry requested and paid for the fraudulent documents.

We have numerous ongoing investigations involving single family loan origination fraud, and specifically property flipping, throughout the United States. In our Housing Fraud Initiative locations, such as New York, Baltimore, Chicago, and Los Angeles, massive property flipping schemes involving FHA-insured mortgages continue to be uncovered. It is our belief that had appropriate controls been in place, these fraudulent activities could have been more quickly identified and the losses minimized.

When we become aware of a fraudulent transaction, we attempt to determine what controls were not followed or what additional controls are needed to prevent it from happening in the future. Our investigations and audits of FHA-insured single family loan originations have disclosed a number of common problems which allow the fraud to occur. The desire of each party (e.g., the lender, broker, appraiser, real estate agent, seller, etc.) to make its fee and/or profit from the financial transaction, the liberalization of FHA underwriting standards, the severe reductions in HUD monitoring staff, and the lack of clearly defined responsibilities brought about by major organizational changes in HUD all combine to increase the vulnerability for fraud.

HUD has undertaken major structural and organizational changes in single family operations over the last five years. These include the consolidation of field operations into four Homeownership Centers, significant staffing cuts in headquarters and field operations, and the contracting out of major portions of the workload. During this period of change, the single family program has been particularly vulnerable to fraud, waste and abuse. Fortunately, a high mortgage insurance premium structure and a very strong economy have enabled FHA to more than meet its capital reserve requirements. However, a future economic downturn could seriously affect the financial well being of FHA's mortgage insurance fund.

In the last year, through our audits, investigations and Housing Fraud Initiative activities, we have examined nearly every aspect of the single family program. This work clearly demonstrates (1) a high incidence of fraud, waste and abuse in FHA's single family operations, and (2) a clear need for HUD to tighten controls over this multi-billion dollar insurance operation.

Our audit and investigative work has disclosed that HUD's current procedures for monitoring lenders, overseeing contractors and supervising HUD staff activities are less than effective. This lack of oversight and accountability can result in criminal activity going undetected. Let me illustrate this with a recent example. Last year, a HUD employee in the Santa Ana Homeownership Center was convicted for accepting bribes and tax evasion. The employee conspired with a real estate agent to carry out a systematic scheme of selling HUD-owned properties at prices far below HUD's listed price. The FHA Insurance Fund lost several million dollars as a result of this scheme. We conducted a review to determine what if any controls would have prevented this occurrence. We found that the controls were there but were not being followed. The Chief Property Officer (CPO) was required to review and sign off on property discounts. This was not being done. We recommended disciplinary action be taken against the CPO for failing to perform his supervisory duties. In response to our recommendation the Department stated that "the CPO at the time would not have been able to perform all the supervisory and monitoring duties prescribed in the Handbook and should not be subject to any administrative actions." It seems that this major breach of internal controls is being dismissed for a lack of staff brought about by recent HUD reforms.

HUD's mortgage insurance risk depends almost exclusively on the reliability of work performed by its direct endorsement (DE) lenders. DE lenders underwrite nearly all FHA insurance. HUD mitigates its risk through lender oversight. Three important HUD monitoring tools should be working to prevent the insurance of fraudulent loans: post endorsement technical reviews of loan underwriting documentation, field reviews of appraisals, and quality assurance reviews of lenders. When used effectively, these tools can highlight problem loans such as property flips. Our audit of HUD's single family loan processes found that HUD monitoring was not focused on lender and appraiser high risk indicators. Rather, HUD's focus was on meeting numerical review goals as set out in its Business and Operating Plan.

*Post endorsement technical reviews*

Post endorsement technical reviews of underwriting and property appraisals are key controls in monitoring direct endorsement lenders. These technical reviews are typically a desk review of FHA case documentation after insurance endorsement. These reviews assess lender compliance with HUD underwriting and appraisal requirements. Most of this work is contracted out with contract costs ranging from $15 to $35 per case. If problems are found during these technical reviews, HUD is to take remedial action.

HUD over-relied on the work of these contractors and HUD was not reviewing contractor performance. The effects of such over reliance were demonstrated by a recent case where Allstate Mortgage Company fraudulently originated over 400 FHA loans totaling $97 million. Seventeen of these loans had undergone post-endorsement reviews by a contractor. The contractor found no significant problems with these loans, even though the loan files showed obvious fraud indicators. None of 17 cases had been re-examined by HUD contract monitors.

Our re-examination of 151 post endorsement reviews found that, in 70 cases, the reviews failed to disclose material underwriting errors. Our review found several reasons why HUD's controls over the post technical review process were not providing meaningful results, including:

- inexperienced staff in critical HUD control positions,
- increased loan volume with fewer staff to monitor lenders,
- no clear operating policies or procedures for Homeownership Center operations,
- outdated handbooks,
- emphasis on quantitative goals, and
- financial disincentives for contractors to find problem endorsements.

Even when significant technical review problems were noted, HUD implemented few if any corrective actions. The post endorsement technical review process can identify questionable employment, fraudulent gift letters or other questionable origination documentation which are commonly found in flipped sales transactions.

*Post endorsement field reviews of appraisals*

Another critical control feature is the systematic testing of property appraisals by HUD. The direct endorsement lender selects the appraiser that sets the value of the property for FHA insurance. With the high loan to value ratio of most FHA loans, an accurate appraisal is critical to minimizing HUD's insurance risk. HUD's procedures call for field reviews of 10 percent of all appraisals. Also, there are additional requirements that assure oversight of each appraiser and each lender's performance and follow-up when problems are noted. We found that these controls were not being followed.

Most of the appraisal field review work was performed by contractors. In several HUD field offices, we found there were no contracts in place and reviews were not being performed. We found several other offices where there was an insufficient number of field reviews being performed. Even when appraisal problems were found during field reviews, HUD was not using the results to take action against appraisers. Branch Chiefs at three HOCs commented that they did not have enough staff to monitor appraisers or to sanction poor performers. As a result, HUD lacks assurance about the quality of appraisals supporting loans processed and approved by lenders. The field review process for appraisals is one of the easiest methods of identifying flip sales. A good quality control check will look at the reasonableness of comparable properties used for valuation purposes.

*Quality Assurance Reviews*

A third important control over direct endorsement lender activity is the on-site monitoring review. These reviews, which are conducted by the Homeownership Centers' Quality Assurance Divisions, are intended to identify and correct poor origination practices. After completion, the Divisions communicate the review results to lenders and request written responses. Lenders are asked to explain the problems noted, list actions taken to prevent future problems, and/or agree to indemnify HUD for possible losses associated with improperly originated loans. While the Quality Assurance Divisions should focus on lenders with high defaults and foreclosures, many low risk lenders were reviewed in order to meet review goals. Even when the Quality Assurance Divisions identified deficiencies during on-site reviews, they were not following up when the mortgagees did not respond to the findings and recommendations. A quality control check of title information in lender files can easily identify evidence of flip sales.

## HUD's Response to the Problem

To address property flipping and other lending abuses, FHA has developed a Fraud Prevention Plan. The Plan identifies a series of new initiatives to address predatory practices targeted at FHA and its borrowers, including inflated appraisals, fraudulent underwriting, property flipping and other lending abuses. FHA's reforms, to protect homeowners from predatory lending, focus on two main areas: (1) providing relief to those FHA borrowers already in distress, especially those who have been victimized by abusive lending practices; and, (2) strengthening FHA endorsement and fraud detection procedures to prevent predatory practices from occurring in the first place. The new reforms build on existing FHA efforts to streamline operations and eliminate abusive practices including the Homebuyer Protection Plan and the Credit Watch Program.

Virtually none of the Fraud Protection Plan measures were in place when we were doing the audits and investigations discussed in this testimony. However, we have briefly looked at the Fraud Protection Plan and we have several concerns. First, who will carry out this effort? The implementation of the plan will be staff intensive. It seems clear from our prior audit work that the Homeownership Centers are not adequately staffed to deal with the many new requirements set out in the plan such as victim relief, loan restructuring and credit repair. This focused effort on "Hot Zones" requires more people. If HUD HOC staff are used, then, something else won't get done. A review of staffing allocations last year by NAPA of the Denver HOC found that office was 1/3 short of staff. Consequently, assigning additional work to the HOCs without people is not the answer. It is more likely that this plan will result in additional work for contractors. Historically, we have seen that HUD does not do a good job of overseeing these contractors.

Secondly, while attempting to accomplish all that is set out in the plan is laudatory--i.e., curing the problems of predatory lending--in reality it may be impractical. Each flipped deal will require an intensive investigative effort. Trying to determine the circumstances and reliability of an appraisal conducted six months or a year ago will be extremely complex. Determining whether or not the buyer received some sort of remuneration from the seller to close the deal will be difficult to assess. Overall, it will require an intensive investigative effort. Also, since the plan will look into all examples of flipping, whether or not the borrower is in default, it will also be an extensive investigative effort.

Our third concern is how will the cost of this plan be paid. Writing down mortgages to the true value of the property will require someone to pay the costs. Will those costs be born by HUD? What is the estimated cost to the FHA fund? Will this result in a litigious effort between lenders, appraisers and HUD? In summary, the FHA Fraud Prevention Plan appears to be only a sketch of proposed actions; we would need some detail to be able to evaluate its potential effectiveness.

Additionally, while the Homebuyer Protection Plan and the Credit Watch program are noted as two new measures to strengthen the FHA program, they are both in their formative stages. We see these as positive measures to assist in identifying problem loans and lenders. The Homebuyer Protection Plan will help in assuring the accuracy of appraisals as well as identifying problem appraisers. But, it is only within the last few weeks that the Department has begun identifying problem appraisers through this process. Also, the Credit Watch Program is designed to withdraw the approval of lenders with the most egregious default records. But the first Credit Watch actions taken by the Department are being legally challenged.

* * * * * *

HUD's announcement of these various initiatives is an important sign that the Department has recognized the seriousness of the fraud pervading its single family mortgage insurance program. However, these initiatives may take several years before they show any substaintial impact on HUD foreclosure statistics. While we applaud the objectives of the initiatives, we note that they are largely in the formative stage, and they rely on a willingness to take enforcement actions that has been historically lacking in the single family mortgage insurance program. Further, for the most part, these initiatives are over and above the day to day responsibilities of HUD's single family staff for preventing fraud and abuse in the first place.

Let's focus on getting the job done right in the first place. Recognizing that HUD's single family staff have been through downsizing, reorganization, and heightened workload expectations, let's step back and figure out how we can make the internal control requirements that are on HUD's books actually work to prevent fraud and abuse. Internal controls will not work without sufficiently trained staff to assure that checks and balances are in place. If the Congress and the Secretary of HUD send a clear message that that's what they really want, then I am confident that the single family staff will be able to figure out how to do it. The problem is, of course, that making internal controls work is generally perceived as a pretty boring endeavor. But that's how real work gets done.

Madame Chairman, I appreciate the concern the Subcommittee has shown about fraud in the single family mortgage insurance program, and the devastating effects it has on individuals and communities throughout this country. I thank you for the opportunity to present the views of the Office of Inspector General at this hearing, and I pledge our full support for your efforts to strengthen the single family mortgage insurance program.

Senate Permanent Subcommittee
On Investigations

EXHIBIT # 1

June 9, 2000

This affidavit is to inform the subcommittee that if I am called to give testimony before the subcommittee at a deposition, I will assert my Fifth Amendment right not to answer.

RICHARD NELSON

Subscribed and sworn to before me this
9th day of June, 2000.

Irma Pulido
Notary Public

Expires: 5/17/02

"OFFICIAL SEAL"
IRMA PULIDO
NOTARY PUBLIC, STATE OF ILLINOIS
MY COMMISSION EXPIRES 5/17/2002

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Senate Permanent Subcommittee
On Investigations

EXHIBIT # 2

# The Report of

# The Baltimore Task Force on Predatory Lending

June 28, 2000

Table of Contents

## I. Background and Mandate: The Need for Action

In April of this year, the nation's homeownership rate reached a record high with 67.1% of American families owning their own homes. This meant that a total of 70.7 million families owned their homes, an increase of 8.3 million since 1993. In addition to the overall increase, record high levels of homeownership were also recorded for central city residents, as well as among African American and Hispanic families.

The Federal Housing Administration (FHA) has played a key role in expanding homeownership opportunities by providing mortgage insurance for some 4.5 million first time homebuyers since 1993. The FHA plays a particularly important role in expanding homebuying opportunities for the nation's minorities. In 1999, the FHA insured 222,822 loans for Hispanics, a four fold increase over the 1992 figure. Similarly, in 1999 FHA insured 170,193 loans to African American families, a three fold increase over the number endorsed in 1992.

Despite these gains, too many low- and moderate income families have seen the dream of homeownership become a nightmare because of predatory or abusive lending practices. As documented in this report, many families in Baltimore – including those participating in the FHA mortgage insurance program -- were duped by unscrupulous realtors, mortgage brokers, appraisers, and/or lenders into purchasing homes at an inflated price or a home with significant undisclosed repairs. At a minimum, victims of these practices – commonly known as "property flipping" – must struggle to meet the high monthly payments associated with these inflated mortgages. And in some cases, victims of these abuses quickly fall behind in their mortgage payments, and lose their homes to foreclosure.

As documented in a recently issued report by the U.S Department of Housing and Urban Development and the U.S. Department of Treasury[1], property flipping is an example of a set of abusive practices found in the subprime mortgage market, where record numbers of Americans are financing or refinancing their homes. Subprime lending can serve an important role by providing loans to borrowers who do not meet the credit standards for the prime mortgage market. But there is a growing body of anecdotal evidence that an unscrupulous subset of subprime lenders engage in abusive lending practices that strip borrowers' home equity and place them at increased risk of foreclosure. The explosive growth of subprime mortgage lending has thus created a corresponding increased potential for consumer abuse.

An additional troubling factor about these practices is their apparent concentration in lower-income and predominantly minority neighborhoods.[2] Predatory lending has contributed to the rapid growth in foreclosures in many inner-city communities, a phenomena which can destabilize not only individual families but entire neighborhoods as well.

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[1] *Curbing Predatory Home Mortgage Lending: A Joint Report.* The U.S. Department of Housing and Urban Development and the U.S. Department of Treasury, June, 2000, www.hud.gov/pressrel/pr00-142.html

[2] *Unequal Burden: Income and Racial Disparities in SubprimeLlending in America,* HUD, April 2000.

**A. A Call to Action.** Maryland Senator Barbara Mikulski, under her authority as the ranking member of the VA/HUD Appropriations Subcommittee, held a field hearing in Baltimore on March 27, 2000 to discuss the issue of "real estate flipping" in the City of Baltimore. Over 100 citizens attended the hearing, where they heard from panels of victims, law enforcement officials and state and federal government representatives. The hearing was followed by a walking tour of Baltimore neighborhoods that had been victimized by predatory lenders. The hearing and tour demonstrated that predatory lending had become a significant problem in the Baltimore area.

Three days later, at the urging of Senator Barbara Mikulski, HUD Secretary Andrew Cuomo convened the Baltimore Task Force on Predatory Lending. The Secretary sought to involve a diverse range of groups and individuals in the Task Force who had expertise on predatory lending including Baltimore's Housing Commissioner Pat Payne, Maryland's elected and appointed officials, senior officials from HUD including Assistant Secretaries Bill Apgar and Cardell Cooper and the leading non-profit groups from the Baltimore neighborhoods most effected by predatory lending.[3] The Task Force members met every week for eight weeks, discussing their various findings and recommendations. The Baltimore Task Force was closely coordinated with a National Task Force on the broader range of abusive practices, with a particular focus on abusive practices in the subprime market, formed jointly by HUD Secretary Cuomo and Treasury Secretary Lawrence Summer. A public forum was held on May 19, 2000 in Baltimore as part of the National Task Force. The Baltimore forum served as an opportunity to gather more evidence, hear from more witnesses and specifically learn about the role of other non-lender players such as real estate appraisers and real estate brokers.

The Baltimore Task Force process has been both collaborative and effective. A significant amount of information was gathered in a short period of time and several actions have already been taken by both the City and HUD to help bring relief to the hardest hit communities in Baltimore. This final report presents the accomplishments and commitments of individual Task Force members and groups and different sets of recommendations from a variety of Task Force members representing a range of perspectives. Chapter II presents the recommendations of Ed Rutkowski from the Patterson Park Community Development Corporation and Kenneth J. Strong of the Southeast Community Development Corporation, representatives from Baltimore's non-profit community groups. Chapters III, IV and VI describe the actions taken by HUD and the City of Baltimore to respond to this crisis. Chapter V describes the response of law enforcement agencies. While we have not presented one set of recommendations, a review of the various chapters in this report reveals that there is significant agreement on what should, and will, be done.

[3] A full list of Task Force Members is attached as Appendix A.

The mandate of the Baltimore Task Force on Predatory lending was to examine real estate flipping practices in Baltimore and to recommend and implement solutions. In addition, the Baltimore Task Force served as a "laboratory" for the National Task Force, insights generated in Baltimore were prominently featured in the resulting HUD/Treasury Report on Predatory Lending.[4] The Task Force goals, developed with guidance from Senator Mikulski, were divided up into categories of tasks that "must", "should" and "would be nice" to accomplish.

The "must do" category included:

1. Data collection and analysis;
2. Develop a strategy for responsible disposition of HUD houses;
3. Develop a strategy to refinance scams;
4. Develop a strategy for secondary market regulation;
5. Investigate bad actors;
6. Review future loans at origination;
7. Put in place an FHA moratorium on foreclosures.

The "should do" category included:

1. Develop FHA loan parameters;
2. Upgrade counseling;
3. Develop an early warning system where HUD shares information with neighborhoods about risky loans;
4. Develop a victim clearinghouse;
5. Develop an education campaign against flipping.

The "would be nice to do" category included:

1. Provide demolition money to Baltimore;
2. Provide flexible money for community recovery program;
3. Reinstitute pre-foreclosure sales for FHA loans;
4. Coordinate FHA disposition with disposition of other vacant properties, including City-owned vacants and HABC-owned vacants.

**B. Foreclosures in Baltimore City** Prior to forming the Baltimore Task Force, HUD officials were tracking what appeared to be an unusual increase in foreclosures in the city. FHA data indicated that the number of foreclosures in the city had increased from 215 in 1992, to 403 in 1997. Even as FHA moved to expand lender and appraisal monitoring in Baltimore, foreclosures continued to rise to 815 in 1999. With some 29,637 FHA loans on the books in 1999, the Baltimore foreclosure rate stood at a whopping 2.75 percent. These trends were even more startling since the national foreclosure rate for the same period held more or less stable in the 0.90 to 1.00 percent range.

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[4] *Curbing Predatory Home Mortgage Lending: A Joint Report.* The U.S. Department of Housing and Urban Development and the U.S. Department of Treasury, June, 2000, www.hud.gov/pressrel/pr00-142.html

Clearly, by the Spring of 2000, Baltimore was facing a crisis in foreclosures. Working cooperatively with the staff of the St. Ambrose Housing Aid Center, HUD obtained detailed information on all foreclosure petitions filed at the Circuit Court of Baltimore City for the period January 1, 2000 and March 31, 2000. HUD's Office of Policy Development analyzed data in 1550 foreclosure petitions for the first quarter of 2000 including the petition and origination dates, the interest rate, product type (FHA, VA, conventional), the name of the lender, and the address of the property.[5]

While these data confirmed that FHA foreclosures were still on the rise, they also demonstrated the important role that subprime lending was now playing in Baltimore.

- **The overall subprime share of foreclosures in Baltimore City was 45 percent,** compared with shares of 23 percent for prime conventional loans and 30 percent for FHA loans.

- **FHA accounted for 30 percent of all foreclosure petitions in Baltimore City** during the first three months of 2000 and for 28 percent of mortgage originations during 1998.

The data also demonstrated the disproportionate presence of subprime foreclosures in low-income and minority neighborhoods, the unusual speed with which subprime foreclosures can occur and the important fact that subprime originations are not keeping up with foreclosures in Baltimore:

- **Subprime loans represented a disproportionate share of the foreclosures in Baltimore City's low-income neighborhoods.** Subprime loans accounted for 50 percent of foreclosure petitions in low-income Baltimore City neighborhoods, compared with only 24 percent for prime loans and 25 percent for FHA loans. Subprime originations have not kept pace with foreclosures, making up only 33 percent of all loan originations, as compared with 50 percent of all foreclosures. For prime and FHA loans, the origination percentage is higher than the foreclosure percentage, at 37 percent and 27 percent respectively. (See Figure 1.)

- **Subprime loans had a disproportionate share of foreclosures in Baltimore City's predominantly black neighborhoods.** Subprime loans accounted for 57 percent of foreclosures in predominantly black neighborhoods, compared with only 24 percent for prime loans and 18 percent for FHA. Subprime foreclosures again appear to be out of proportion to their representation in the origination pool of only 33 percent. Prime and FHA foreclosures were more modest than originations, at 36 percent and 22 percent respectively. (See Figure 2.)

[5] HUD used its subprime list of HMDA lenders to identify subprime lenders in Baltimore City. HUD also identified lenders that specialize in subprime lending but either do not report to HMDA or were not identified earlier by HUD.

- **Subprime loans were foreclosed upon more quickly than prime and FHA loans.** The mean lag between the origination date and the date that the foreclosure petition was filed was 1.8 years for subprime loans compared to 3.2 years for FHA and prime loans. Subprime loans originated in 1999 accounted for a large portion (28 percent) of all subprime foreclosure petitions in that year.

- **The subprime share of foreclosures is larger than the subprime share of originations.** While subprime foreclosures accounted for 45 percent of the foreclosure petitions, the subprime share of home purchase and refinance originations in Baltimore City was only 21 percent in 1998.[6]

These data reveal that FHA foreclosures are part of a larger wave of foreclosures that are sweeping the city. The challenge for the Baltimore City Task force was to identify how best to address issues relating to FHA foreclosures, while at the same time addressing the abusive practices in the non-FHA portion of the market in order to create a truly comprehensive solution to the problems confronting the city and especially it's low- and moderate income neighborhoods.

[6] The subprime share reported for 1998 may be the most useful share when comparing the subprime share of foreclosures with the subprime share of originations since 61 percent of subprime foreclosures in Baltimore City were for subprime loans originated since 1998. The subprime share of the market is derived from purchase and refinance loans that are reported to HMDA since the foreclosure data includes purchase and refinance loans. As noted earlier, the subprime origination shares reported in this section for home purchase and refinance loans in Baltimore City differ from the subprime share of purchase and refinance loans in the Baltimore metropolitan area.

## II. Baltimore's Advocacy Community's Recommendations for Action

### A. Recommendations of Ed Rutkowski, Patterson Park Community Development Corporation

#### (1) Identification of Areas at High Risk of FHA Foreclosure: The "Second-Tier" Market for FHA-Insured Loans

Based on experience in East Baltimore, it is clear that some areas (e.g. census tracts, neighborhoods) are more likely to have significantly higher defaults rates than other areas. Further, this happens to such an extent that HUD/FHA may be said to operate two different programs:

- A program in which the vast majority of FHA-insured loans are successful, with low default rates that enable people to become homeowners: this program operates primarily in suburban areas, but also in stable urban communities.

- A "second-tier" program in which default rates are unacceptably high and personal failures costly, to individuals, their communities, and to FHA and the banking industry: this program operates primarily in urban areas, though failing inner-ring suburbs are likely candidates as well.

In the past few years, the "second-tier" program areas have also been the targets of widespread fraud, both in FHA-insured loans, as well as private market loans, especially the sub-prime market. Victims of fraudulent mortgage schemes include overwhelmingly poor, uneducated and minority families, as well as the communities in which they live.

HUD/FHA has been both perpetrator and victim. HUD/FHA has eased requirements for FHA-insured loans (sometimes at congressional insistence), used national statistics to mask the two-market phenomenon, and inadequately monitored factors that destabilize areas in which FHA insures loans. By doing so, HUD/FHA has contributed to individual failure, neighborhood collapse, and unnecessary losses in "second-tier" program areas.

A map of 1999 claim rates produced for the Baltimore Task Force showed that in 202 census tracts city-wide, 76% had a claim rate less than 3.57%. Yet, 18% had claim rates between 3.57% and 7.32%, and 6% had claim rates above 7.32%. A map of actual claim activity indicated that 4% of the census tracts in Baltimore City would account for 112 - 184 foreclosures, at a cost to FHA in 1999 alone of $4,000,000 - $6,500,000.

We believe that much of the cost and heartache could be prevented if action were taken early enough. The first step in prevention is identification of risk. We therefore recommend that HUD/FHA undertake the following:

- Develop a methodology that will allow HUD/FHA to identify areas in which FHA foreclosures are, or have recently been significantly higher than national averages.

- Develop an Early Warning System that will detect areas that are likely to experience high FHA foreclosures in the future.

- Create an investigative team that can determine the reasons for, and possible defenses against the causes of high FHA foreclosure rates in the areas described above.

In Baltimore, HUD's laboratory, we recommend that HUD establish an entity to develop the above for Baltimore City. That entity would report its findings, methods and recommendations within two months.

**(2) Modification of HUD/FHA Practices in "Second-Tier" Program Areas**

The section "Identification of Areas at High Risk of FHA Foreclosure" recommends that HUD/FHA create appropriate tools to identify the relatively small number of areas (e.g. census tracts, neighborhoods) where a "second-tier" program for FHA insurance exists. These areas are primarily urban, but include failing inner ring suburbs. They often include neighborhoods "in transition" where racial and class change destabilizes communities and offers opportunities for the unscrupulous to take advantage of the poor and uneducated.

Default rates are unacceptably high in "second-tier" program areas for a number of reasons. The underlying, base rate is typical for the nation as a whole and is caused by the usual reasons: loss of job, serious illness, etc. Rates may be somewhat higher in such areas because incomes are relatively fragile, families more often have only one income, etc. However, two conditions cause foreclosures to increase dramatically.

As noted above, these may be "transitional areas," where middle-class flight is exaggerated by an increasing drug trade, where schools continue to fail, and where real estate values are dropping. Too often people cannot sell their homes for enough money to pay the mortgage, and rather than remain in a deteriorating neighborhood, they walk away from the mortgage. Also, in recent years, the number of foreclosures has exploded due to the well-documented schemes of unscrupulous sellers. Schemes range from taking modest advantage of uneducated buyers to outright fraud involving tens of thousands of dollars in each transaction.

There is every reason to believe that modifications to HUD/FHA policy would lead to dramatic improvements in outcomes for individuals, communities, and HUD/FHA's bottom line. We therefore recommend that HUD/FHA undertake the following in "second-tier" areas:

- Tighten FHA practices with respect to making loans in these areas, especially to "high-risk" individuals. New practices, such as thorough loan review at origination, would be specially targeted to detect and prevent fraud and consumer deception. Moratoriums on foreclosures would create time to investigate fraud, offer pre-foreclosure counseling, and develop mortgage modification and refinancing options for qualified victims.

- Establish parameters for FHA-insured loans that increase the likelihood that a buyer will be successful. Examples include, but are not limited to restrictions on interest rates and points, narrow interest ranges for adjustable rate mortgages, improved home inspection procedures, and increased homeownership counseling and education.

- Adopt policies that limit the number of HUD houses and the length of time they remain vacant. These include increased efforts in "work-outs," pre-foreclosure sales, and rapid turnover of foreclosed houses to responsible entities.

- Rather than subsidize claim losses with premiums from the "first-tier" FHA market, use premiums to subsidize neighborhood redevelopment in "second-tier" markets. For example, in the Patterson Park area of Southeast Baltimore, there were about 65 FHA foreclosures in 1999. That represents a loss of at least $2,000,000 to HUD.

In Baltimore, HUD's laboratory, we recommend that HUD/FHA adopt the above policies in three Baltimore City neighborhoods to test ability to restore neighborhood stability and reduce foreclosure rates. The test would last for five years, employ a significant research component, with an annual investment by HUD of up to $2,000,000 per neighborhood.

**(3) Disposition of HUD-Owned Properties**

HUD's REO (Real Estate Owned) inventory exists in three types of areas:

- areas that can be thought of as FHA's "first-tier" market area where homeownership is strong, where HUD houses are in marketable condition and can be sold to homeowners;

- areas like those described in other sections in this report that can be defined as within the "second-tier" FHA market (these areas are especially addressed in the section "Disposition of HUD-Owned Properties in 'Second-Tier' Program Areas"); and

- areas ("third-tier") where homeownership is unlikely at best, where there is no responsible organization to redevelop vacant and abandoned properties, and where HUD properties may be subject to continued vandalism.

Within HUD's "second-tier" market there are neighborhoods where there is no CDC or other responsible entity to redevelop HUD houses. In these neighborhoods, homeownership is also unlikely. For example, in a study of Patterson Park neighborhoods before the existence of the Patterson Park CDC, from 1990 through 1996, of 109 HUD sales, at most 22 went to homeowners. With the exception of 3 sales to city-wide non-profits, the rest (77%) were sold to investors who usually rented the properties after cosmetic renovation.

These circumstances exist in many neighborhoods in Baltimore City and throughout the nation. The net effect is that HUD washes its hands of its REO inventory in "second-" and "third-tier" areas where CDC's (or other responsibilities) do not exist. HUD simply sells its properties to the highest bidder, if any, and walks away from circumstances to which it, and the federal government have contributed.

HUD/FHA must recognize the very different conditions of the areas in which it owns foreclosed houses and develop strategies appropriate to each area. We therefore recommend that HUD undertake the following with respect to disposition of its REO inventory:

- Use the recommendations of the section "Identification of Areas at High Risk of FHA Foreclosure" to identify "first-" and second-tier" markets.

- Continue its existing programs in "first-tier" markets.

- In "second-tier" markets, issue RFP's to determine the existence and capacity of organizations/developers capable of responsible redevelopment of HUD houses. Use the principles of the section "Disposition of HUD-Owned Properties in 'Second-Tier' Program Areas" to dispose of HUD properties in these areas.

- In "second-tier" markets without such organizations and in "third-tier" areas, develop a strategic plan in conjunction with local government for property disposition. Elements of the plan would include demolition, funds for long-term land banking, etc.

In Baltimore, HUD's laboratory, implement the above recommendations to test the results. Compare results to disposition results in prior years.

See the next section, "Disposition of HUD-Owned Properties in 'Second-Tier' Program Areas," for specific application to those areas.

**(4) Disposition of HUD-Owned Properties in "Second-Tier" Program Areas**

The section "Identification of Areas at High Risk of FHA Foreclosure" recommends that HUD/FHA create appropriate tools to identify the relatively small number of areas (e.g. census tracts, neighborhoods) where a "second-tier" program for FHA insurance exists. These areas are primarily urban, but include failing inner ring suburbs. They often include neighborhoods "in transition" where racial and class change destabilizes communities and offers opportunities for the unscrupulous to take advantage of the poor and uneducated.

Those factors lead to high foreclosure rates. In such neighborhoods, foreclosure rates are already abnormally high because neighborhood decline and dropping property values force people to walk away from their mortgages when selling prices are insufficient for mortgage payoff. These conditions concentrate large numbers of HUD houses. HUD houses often lead to neighborhood decay in "second-tier" areas because they are obviously vacant, often unattractive, badly maintained, targets for use by vagrants and drug-users, etc.

Further, in such neighborhoods, HUD rarely sells to homeowners. By contrast, HUD claims a high percentage of sales to homeowners nationwide. To illustrate, in a study of Patterson Park neighborhoods from 1990 through May, 1999, of 186 HUD sales, at most 29 went to homeowners. Since 1997, of 77 HUD sales, while 27 went to the Patterson Park CDC, 29 were sold to known "flippers."

Problems with HUD's "one size fits all" approach to property disposition is compounded by the difficulty of acquiring accurate appraisals. As typified by East Baltimore, property values can vary dramatically from block to block. Dramatic differences in property condition are rarely taken into consideration. Finally, in an effort to limit loss, HUD allows repair escrows that can never bring properties to condition marketable to knowledgeable homebuyers. These practices only lead to further neighborhood deterioration.

It is imperative that HUD refine its disposition practices to consider the specifics of the neighborhoods in which it sells. We therefore recommend that in "second-tier" program areas HUD adopt different policies:

- In areas with CDC's (or other responsible entities) capable of appropriate disposition of HUD houses, adopt less restrictive rules, thereby taking advantage of the opportunities that existence of those entities represents. A model is available in the proposal of the Patterson Park CDC for an Asset Control Area.

- In areas where appraisals are suspect, rely on local entities to determine property value. In this respect, "local" does not mean an appraiser licensed in the regional MSA, but rather an appraiser who is intimately familiar with conditions within the neighborhood. All appraisals should be reviewed by the local CDC.

- The research component referenced in other sections in this report should identify buyers who are unlikely to be responsible to the community, including known "flippers," investors who are known to manage "problem" properties, etc. HUD should not sell to these buyers.

In Baltimore, HUD's laboratory, we recommend that HUD establish a city-wide entity to dispose of all properties in accordance with the above recommendations.

**(5) Recovery Plan for Communities Damaged by HUD/FHA Practices**

There is considerable evidence that the recent episode of mortgage fraud has affected the City of Baltimore more devastatingly than any city in the country. Much of that fraud has been perpetrated using FHA insured mortgages as a tool. The sub-prime market, ineffectively monitored by the federal government, has been another major contributor.

Within Baltimore City, several neighborhoods have clearly suffered more than others, notably Patterson Park, Belair-Edison, and Govans. As noted in the section "Modification of HUD/FHA Practices in 'Second-Tier' Program Areas," these are transitional neighborhoods already stressed by the destabilizing forces of racial and class change. Neighborhood deterioration has been exaggerated by the high foreclosure rates and HUD's inadequate disposition practices.

In Baltimore City, current problems were preceded by mismanagement of the Section 8 program by the Housing Authority of Baltimore City. HUD funds the Section 8 program and is ostensibly responsible for its oversight. Section 8 mismanagement, in conjunction with deceptive and fraudulent mortgage practices have had devastating effects on neighborhoods in Baltimore City, particularly those mentioned above.

These neighborhoods represent the future of the City as a whole: they will either continue to decline and ultimately fail as so many neighborhoods have, or they will recover to lead the City's revitalization. By virtue of HUD's and the federal government's responsibility for factors that have exaggerated if not prompted decline, and their responsibility to "Urban Development," HUD should adopt specific recovery plans for the most affected neighborhoods.

Once a pattern of neighborhood decline has been set in motion, or exaggerated by HUD practices mentioned above and in other sections in this report, wholesale disintegration of stabilizing neighborhood structures ensues. That is to say that simply changing the practices that led to deterioration is not sufficient; the neighborhood fabric must be rewoven. We therefore recommend the following efforts in neighborhood recovery where HUD and the federal government have played a significant role in neighborhood deterioration:

- Using the recommendations of the section "Identification of Areas at High Risk of FHA Foreclosure," identify a series of neighborhoods nationwide where a recovery plan based on the above principles is appropriate.

- Implement recovery plans in those neighborhoods at a level appropriate to test the feasibility in a variety of circumstances, and in a way that advances knowledge of comprehensive neighborhood revitalization in the 21st century.

In Baltimore, HUD's laboratory, special attention should be focused on Patterson Park for a variety of reasons:

- the existence of a plays in defense of other stable and revitalizing neighborhoods of southeast Baltimore, including their high number of FHA-insured mortgages.

**(6) Establish a Victim Clearinghouse**

Mortgage and refinance fraud has taken a great toll on its victims, and more people and families are becoming victims every day. These families face loss of their homes, ruined credit, harassment by lenders, bankruptcy, and an uncertain, but miserable future.

In Baltimore alone, the number of such victims numbers in the thousands, and may number in the hundreds of thousands across the country. Yet there is no place that these families can turn for consistent, helpful advice. The legal case which sparked the sequence of events leading to the creation of the HUD Flipping Task Force was purely a matter of chance – a home was accidentally demolished by the City of Baltimore leading the owner to a lawyer, Andre Weitzman. Mr. Weitzman in turn solicited the help of Mr. Ken Strong of the Southeast Community Organization, who in turn solicited the help of other non-profits, government agencies, the press, and influential politicians like Senators Mikulski and Sarbanes.

Most of the other thousands of victims are not so fortunate. They don't know where to turn. Even if they have been defrauded, it is rare that they will find their way to someone who can really help. Agencies often don't know what can be done themselves.

As this is written, FHA has made a great effort both to prevent future fraud and to take action to remediate past fraud. Their efforts include a moratorium against foreclosures in Baltimore, suspending loan originators who are statistically implicated in poor practice, publishing names of appraisers associated with bad loans, demanding principal reduction of fraudulent loans, restoring credit ratings, and providing vouchers for pre-foreclosure counseling.

Still, knowledge of what can be done to help victims is confined to a few agencies familiar with what has happened. Knowledge of all the fraudulent schemes is not complete. Many families don't know they have been defrauded, and believe their problems are their own fault.

Efforts must be made to create a compendium of options available to the victims of fraud, to educate people who can help the victims, and create an effective mechanism for victims to find help. We therefore recommend that HUD/FHA:

- Establish and/or fund victim clearinghouses where families that have been defrauded can get sound advice, where information can be collected about the methods of the scam artists, where appropriate legal/financial assistance can be provided

- In conjunction with the "Education Plan . . ." section, exhaustively publish clearinghouse locations, phone numbers, and the services that are provided. Include in the services counseling that will prevent families from becoming victims.

In Baltimore, HUD's laboratory, we recommend funding a model victim clearinghouse at the location of a city-wide non-profit organization. Activities and services of the clearinghouse would include:

- Publicize the availability of assistance and means to access the clearinghouse.

- Evaluate the circumstances surrounding the client. Gather information from victims to establish perpetrators, methods, etc.

- Where fraud has been involved, use tools provided by FHA to provide the best possible outcomes for the family. Include legal remedies where appropriate.

- Where fraud has not been involved, help the family understand their options.

### (7) Education Plan to Prevent Victimization by Predatory Lending Practices

In spite of widespread publicity surrounding mortgage and refinance scams, the public remains susceptible to outrageous claims of those who perpetrate these kinds of fraud. TV stations continue to run ads that would not get a glance from the knowledgeable. The existence of these ads alone points to the continuing pool of potential victims.

Many of the victims are poor and uneducated, and their circumstances make them vulnerable to the claims of the scam artists. It is from this group that scam artists make their money. Without a pool of such targets, the perpetrators would be unable to stay in business.

The goal of an education plan must be to reach the pool of potential victims, alert them to the dangers of mortgage and refinance fraud and provide alternatives. We therefore recommend that HUD/FHA fund education efforts and work with government agencies and non-profit organizations to:

- Develop a plan to alert the public, especially those most susceptible to the possibility that they will become victims.

- Develop a plan to educate those most able to counsel potential victims and prevent fraud. The plan should include education about alternatives for potential victims. Education must be provided for counseling agencies, loan officers, etc.

- Help fund and implement the plans.

In Baltimore, HUD's laboratory, we recommend that HUD/FHA convene a work group to develop and implement the activities described above. The group would consist of government agencies, non-profit organizations that provide housing counseling, banks, PR specialists, and real estate agents. The effort must work in conjunction with the Victims Clearinghouse to ensure that one entity is the center of knowledge for all of the prevention and remediation efforts. HUD/FHA should then provide significant funding for the activities defined by the work group.

### (8) Secondary Market Regulation

Much of the fraud that has been committed is made possible by the existence of a secondary market in mortgage-backed securities. Too often, fraud is simply too easy to perpetrate. Faked documents, forged signatures, and inflated appraisals are impossible to detect by the buyer of such securities – an office in San Francisco may buy mortgages from Baltimore where it is inconceivable that an appraisal of $70,000 can be greatly overstated.

Unfortunately, the damage that can be wrought by such fraud greatly weakens urban neighborhoods. The perpetrators have gotten their cash, put their loan origination operation out of business, and disappeared. Averaged over all of the mortgages purchased, the buyers do not suffer too much, but the neighborhoods where this fraud developed suffer greatly.

Within the last ten years, the emergence of the sub-prime market has greatly exaggerated the potential problems by making sub-prime loans look terrific on paper with high interest rates on large-equity loans. As with the junk bonds of the 80's, the loans aren't as good as they look.

Unlike junk bonds, however, the victims are not just the individual investor. The victims are also the neighborhoods like those under the spotlight in Baltimore. These are neighborhoods of relatively low income residents, neighborhoods already destabilized by urban stresses and demographic change, and neighborhoods in which the federal government has some obligation to protect.

The non-profit organizations that are originating these recommendations cannot claim to be experts in the intricacies of the secondary market. However, something must be done. We therefore recommend that appropriate federal agencies:

- Investigate the role that the secondary market has played and continues to play in the ability of scam artists to perpetrate mortgage and finance fraud.

- Use the authority of HUD to force holders of fraudulent mortgage loans to reduce the amount and terms of such loans to appropriate levels, even if the loans were purchased without fraudulent intent.

- Gather statistical information about loans that result in foreclosure. Widely publish results as they reflect on loan originators, appraisers, real estate agencies, etc.

- Implement other regulations as dictated by the investigation above.

In Baltimore, HUD's laboratory, we recommend that HUD/FHA test their ability to force the above recommendations for loans believed to be fraudulent as detected by research HUD/FHA has performed for the task force.

**B. Recommendations of Kenneth J. Strong, Southeast Community Development Corporation: A Recovery Plan for the Neighborhoods of Patterson Park**

**(1) Overview**: The neighborhoods of Patterson Park have suffered and are threatened by some of the nation's worst mortgage scams and "flipping" schemes. Hundreds of houses in this community have been bought and sold quickly in transactions that involve fraud and deception. In the wake of these transactions are families entrapped in under-repaired and over-valued houses they cannot afford. The end result is foreclosure, abandonment, displaced families, vacant houses, and neighborhood disintegration.

Research by the South East Community Organization (SECO) has shown that the neighborhoods of Patterson Park (Monument Street on the north, Fleet Street on the south, Patterson Park Avenue on the west, and Haven Street on the east) have Baltimore's highest concentration of houses flipped in the past five years. Figures three and four show thick clusters of black dots representing houses bought and sold quickly in which the sales prices increased by more than 100% from 1990-1999 and more than 50% from 1995-1999. Research by the National Training and Information Center (NTIC) also shows that Baltimore ranks the highest in the country on indices for FHA foreclosures and houses in the HUD inventory. Federal housing programs and abuses of those programs have contributed to the housing crisis in Baltimore, and especially in the neighborhoods of Patterson Park. Patterson Park neighborhoods have an exceptionally high concentration of federally subsidized rental properties; in this community, there have been numerous documented abuses of the program.

Secretary Andrew Cuomo titled a recent HUD report on subprime lending "Unequal Burden" emphasizing income and racial disparities in the lending marketplace. Within the nation Baltimore bears an unequal burden as it relates to mortgage scams, flipping schemes, FHA foreclosures, and the HUD vacant house inventory. And within Baltimore, the neighborhoods of Patterson Park bear an unequal burden on these same indices of housing stress. While we do not have a definitive analysis of why Baltimore, and the neighborhoods of Patterson in particular, bear unequal burdens, it does appear that racial change in neighborhoods is a significant factor. We feel that the neighborhoods of Patterson Park were targeted by real estate and lending predators as a modern form of "blockbusting." It shows on the maps in the attachments that other neighborhoods experiencing racial change also have high concentrations of flipping and foreclosure. This raises the importance of the recovery plan as a defense and response to new forms of housing discrimination.

To recover from the dire situation which is blighting the central neighborhoods of southeast Baltimore, SECO, and its sister organization Southeast Community Development Corporation (Southeast CDC) propose a comprehensive strategy. We are joined by a strong team of partners in making this proposal: Neighborhood Housing Services of Baltimore, Banner Neighborhoods Community Corporation, Friends of Patterson Park, Centro de la Comunidad, and ClearingHouse for a Healthy Community. The Patterson Park Community Development Corporation is seeking a line item in the federal budget for a million dollars to continue its housing interventions in much the same area; we support their efforts. Southeast Baltimore is fortunate to have many community development corporations and non-profit agencies with depth, talent, expertise, and a willingness to work together. What they have lacked are the resources to match the scale of the negative forces impacting the neighborhoods of Patterson Park.

This proposal is based on the concept that a community recovers from the blighting influences of mortgage scams and flipping schemes through a comprehensive strategy involving housing programs, commercial revitalization, community organizing, and services to families. So much havoc has been wreaked on the neighborhoods of Patterson Park for so long that housing programs alone will not stabilize this community. The coordinated work of several community organizations, strengthened by federal support, will do so.

**(2) Structure of the Proposal**: SECO is the long standing umbrella community organization for the southeast quadrant of Baltimore City and has a thirty-year history serving as the area's vehicle for community democracy and as a provider of human services. Southeast CDC (formerly Southeast Development Incorporated) has a twenty-five year record of housing development, home ownership counseling, and commercial revitalization. SECO and Southeast CDC will jointly administer this grant through their common executive director/president and administrative staff. Partners in the project will act as sub-contractors performing various functions and managing certain aspects of the recovery plan. One of the functions of SECO and Southeast CDC will be to insure that the synergy of several groups working in tandem is maintained.

SECO and Southeast CDC will continue to provide certain services which will complement the recovery plan. SECO, for instance, works closely with the Southeast Education Task Force and oversees community organizers to improve parent involvement and schools in the neighborhoods of Patterson Park. Education-oriented organizing will continue at least through the next year with funding from the France-Merrick Foundations and the Baker Foundation. SECO oversees the South East Senior Housing Initiative (SESHI) which recently won a Robert Wood Johnson Foundation grant of $455,000 to coordinate home improvements for seniors especially in southeast Baltimore. Southeast CDC provides traditional home ownership counseling with CDBG funding from Baltimore City; we expect to continue those services and complement them with the specialized counseling described in the recovery plan. Other SECO and Southeast CDC services will extend and adjust themselves to be partners in the recovery plan. SECO's adult literacy program, one of the best in the state, will design and implement a financial literacy program for its students and the community-at-large. HUD and HCD will leverage many other programs and resources by investing in SECO and Southeast CDC as agents of recovery for the neighborhoods of Patterson Park.

SECO and Southeast CDC are already working with victims of mortgage scams who were represented by a local attorney, Andre Weitzman. Two families who were sold houses at levels of $84,000 and $82,000 have been resettled with mortgages at true values of $38,000 and $37,000 with interest rates of 8.5% and rehab funds structured in the loan guaranteed by the Abell Foundation. We are working with thirty other families who we hope to resettle similarly. We are also working with First Mariner and Chase Manhattan to pilot FHA's creative loss mitigation strategy to give homeowners in flipped properties a fair deal. We have been in the leadership in Baltimore City bringing attention to this problem, organizing a city-wide coalition, assisting mortgage scam victims, and seeking creative solutions to the problem of flipping. The recovery plan will reinforce all of these and take our community to a new level of revitalization.

**(3) Elements of the Recovery Plan**:

**a. Legal Assistance** – SECO co-founded and convenes the Coalition to End Predatory Real Estate Practices which brings together housing and community groups from every part of the city, government agency personnel, fair housing experts, real estate professionals, and legal services groups to focus on these problems. In coalition meetings the need to coordinate legal services to people entrapped by mortgage scams became apparent. To meet this need, we propose to hire a half-time attorney, with assistance and professional supervision, from either the Community Law Center or Civil Justice, Inc. Three law school interns will aid the attorney. The legal team will act as a clearinghouse for cases that should be referred for civil or criminal action, for individual or class action consideration, for arbitration or loss mitigation services, etc. The team will also advise SECO and its member agencies and neighborhood associations on actions they can take against real estate predators in the Patterson Park area. The legal team will work closely with a Community Law Center attorney now working with the Patterson Park Neighborhood Initiative on nuisance abatement cases.

**b. Social Work, Outreach, and Education** – Families entrapped by mortgage scams often need the help of a professional social worker to sort out the complexity of their situations and to help get families on a positive track. Southeast CDC has employed a Housing Counselor with an MSW degree who has concentrated on helping the victims of mortgage scams. We want to continue the dual function social work and housing counseling. We want to extend the services of that individual by engaging three MSW students as interns. Both legal student interns and MSW students will be engaged in community education to prevent mortgage scams. They will visit neighborhood associations, churches, and places of work to forewarn people of the risks of home ownership and the importance of counseling services. The interns will use material now being developed by the Consumer Protection Division of the Maryland Attorney General's Office.

**c. Expanded Housing Counseling Personnel** – To meet the increased demand for housing counseling services, Southeast CDC will hire an additional counselor for two years. This counselor will be especially trained to implement FHA's new strategies to redress the problems of flipping and predatory lending. Centro de la Comunidad has partial funding for a home ownership counselor through the Goldseker Foundation. The recovery plan will allow for that counselor to be full-time for two years. This will insure that Hispanic families have counseling to prevent scams but also that new Hispanic homeowners are attracted to Patterson Park neighborhoods and assisted by a bi-lingual counselor. We already work closely with other housing counselors in southeast Baltimore and will increase that coordination as part of the recovery plan

**d. Community Organizing** – Through our experience, we have learned that community organizing is an important component of a community response to this kind of housing crisis. Existing neighborhood associations need to be part of the solution and help prevent the spread of flipping. Community organizing needs to help old and new residents deal with racial change and increased diversity; we need to combat the psychology that enables "blockbusting" to occur. We also need to strengthen communities in their public safety efforts. Toward these ends, SECO will employ a community organizer to concentrate on the neighborhoods of Patterson Park.

**e. The Patterson Cultural Center** -- The neighborhood commercial corridor of Eastern Avenue has suffered as the neighborhoods have suffered. Southeast CDC, in partnership with the Fells Point Creative Alliance, has embarked on a major project that will anchor the redevelopment of Eastern Avenue. The Patterson Cultural Center is an old neighborhood movie theater being converted to artist housing, gallery, café, and small theater. This project has received significant state funding but needs two million more dollars to be completed. $500,000 will go a long way to reaching our goal for this dynamic project; other funding is expected to come from foundations and various government agencies.

The Patterson Cultural Center represents the future of Highlandtown and the neighborhoods of Patterson Park. It will attract artists to the community as visitors and homeowners. It will spur the commercial revitalization of smaller properties nearby. It is a centerpiece of Southeast CDC's efforts to bring Highlandtown to life and it has an appropriate place in this recovery plan.

**f. Home Improvement Matching Grant Program** – This program, to be administered by Neighborhood Housing Services of Baltimore (NHS), will provide matching funds for homeowners up to $5,000 for home improvements. It will be an incentive to existing homeowners to stay, new homeowners to come, and for families whose FHA loans are restructured. Where it geographically fits, the program will require, and provide the funds, for families to participate in the Home Value Guarantee Program, informational flier attached. This special program of the Patterson Park Community Development Corporation and the Abell Foundation guarantees that houses values will remain stable for families who make a long-term investment in the neighborhood.

**g. Banner Neighborhoods Community Corporation** will undertake two functions as part of the recovery plan. First of all, Banner will transform 25 vacant houses through high quality boarding and securing. These vacant houses will be so attractively secured at $5,000 per house that they will not blight the neighborhood. The houses will be strategically chosen so that whole block is either occupied or appears to be so. Additionally Banner will use a current employee as the operator of a Madvac (purchased with recovery plan dollars) to improve sanitation in the neighborhoods and along the commercial corridor.

**h. Patterson Park** – The neighborhoods of Patterson Park surround a beautiful and sizable urban park. It is a great attraction for new homeowners and could be the centerpiece of our community revitalization. Funds are needed to help complete the perimeter improvements that tie the residential areas together with the park. Funds have been provided by a local foundation to employ events' coordinator who will generate more activities bringing the park and its neighborhoods back to life.

**i. Healthy Homes** – A new organization has formed in southeast Baltimore to address issues of urban environmental health. We are requesting $125,000 to launch their pilot program, the Healthy Homes Project. It will identify 25 houses at risk for serious health problems due to conditions of the house – lead poisoning, asthma, carbon monoxide poisoning, etc. Community residents will be trained to conduct home assessments and interventions, and they will be educated on the maintenance of a healthy home. At the end of a one year pilot, the program will be evaluated by the Johns Hopkins Urban Environmental Health Center.

**(4) Personnel** – Organizations such as SECO and Southeast CDC can supply talented personnel to carry out this plan. There is a strong reserve of talent and expertise to call upon in these organizations and throughout the community.

**(5) Summary and Conclusion** – This is a unique proposal that reflects the role of SECO and Southeast CDC as umbrella organizations in this area of Baltimore. Under the umbrella, we have brought the substantial expertise of NHS, Friends of Patterson Park, Centro de la Comunidad, Banner Neighborhoods Community Corporation, and the Clearing House for a Healthy Community. We will also tap into the assistance of the University of Maryland professional schools in law and social work, agencies for emergency assistance, neighborhood associations, churches, and the Patterson Park Community Development Corporation. Few neighborhoods, so afflicted and undermined by housing crises, have the richness and diversity of non-profit agencies and community associations that we have in southeast Baltimore. The recovery plan builds upon and strengthens the work of these partners; it also brings them closer together in their work.

The recovery plan provides a basis upon which to raise additional funds from other sources. We need more resources for emergency assistance in the neighborhoods of Patterson Park. Our appeals for funding to groups like the United Way will be greatly enhanced by the two-year comprehensive investment in the community envisioned this recovery plan.

Two years from now there will be fewer victims of mortgage scams due to our efforts. Many people who were entrapped by these schemes and predators will have new mortgages they can afford at true appraised values. Many current and new homeowners will invest in their properties with guarantees that their property values will not fall. Twenty-five vacant houses will be attractively secured; they will not be eyesores or detriments to the block. Twenty-five houses will be safer and residents will be trained in environment health protection in their homes. The entrances to Patterson Park will be attractive gateways for both park users and nearby residents of the neighborhood. The Patterson Cultural Center will be up and running as housing for artists and a magnet for area visitors. The Hispanic community will grow and contribute to the diversity of the area. And the recovery plan will have sparked interest from private foundations and other levels of government to complement our efforts. A neighborhood in transition will be stable, a place to be proud of, home to a diverse community, and a model for the city and the country.

**(6) Budget Summary**

SECO and SOUTHEAST CDC

| | |
|---|---|
| Legal Assistance - Including one half-time lawyer and three interns | $86,000 |
| Social Work, Outreach and Education - Including MSW and three interns | 136,000 |
| One Housing Counselor - | 80,000 |
| One Community Organizer - | 80,000 |
| Patterson Cultural Center - | 500,000 |
| PARTNERS | |
| Home Improvement Matching Grant Program (Neighborhood Housing Services) | 500,000 |
| Vacant House Stabilization - (Banner Neighborhoods CC) | 125,000 |
| Patterson Park Improvements - (Friends of Patterson Park) | 125,000 |
| Housing Counseling Support - (Centro de la Comunidad) | 60,000 |
| Healthy Homes Project - (ClearingHouse for a Healthy Community) | 125,000 |
| Sanitation Support, MADVAC - (Banner Neighborhoods CC) | 50,000 |
| Subtotal - | 1,867,000 |
| Administrative Overhead @ 10% - (SECO and Southeast CDC) | 186,700 |
| **TOTAL -** | **$2,053,700** |

## III. HUD Responds

### A. FORECLOSURE MORATORIUM AND BALTIMORE SWAT TEAM

Concerned about the high rate of FHA foreclosures and, at the suggestion of the Baltimore Task Force, FHA's National Loss Mitigation Center (NSLMC) issued a 90-day foreclosure moratorium to all lenders and servicers located in the Baltimore metropolitan area. NSLMC also sent staff to Baltimore to work side-by-side with the Philadelphia Home Ownership Center to develop and implement an appropriate action plan.

The purpose of the moratorium was to stop the foreclosure process and create an opportunity for HUD, in partnership with the Task Force, to put a SWAT team in action to: (1) conduct an intensive review of loans in danger of foreclosure to identify evidence of fraud or predatory practices; and, (2) conduct intensive foreclosure avoidance counseling and assist as many homeowners as possible to avoid foreclosure and retain ownership of their homes.

#### (1) HUD's Fraud Protection Tool Kit

HUD was able to first turn to and then build on its extensive Fraud Prevention Tool Kit in responding to the Baltimore crisis. The Tool Kit is comprised of a set of national initiatives that have been implemented over the last three years, including the following:

*a. Lender Monitoring and Enforcement*

Over the last three years, HUD has taken a number of steps to more clearly hold its lender partners accountable for their actions. Although the vast majority of our lender partners act responsibly, FHA recognizes that even a small handful of irresponsible lenders can cause tremendous harm to individual borrowers, and ultimately create losses for the FHA insurance fund. Therefore, HUD has instituted a number of initiatives designed to enhance FHA's lender enforcement activities, including:

- **Credit Watch, a new performance-based lender monitoring and enforcement system**: Under this system, launched in May, 1999, FHA reviews all participating lenders' loan default and claim rates by geographic area on a quarterly basis, and immediately moves to terminate those with the most egregious performance records. In less than one year of operation, FHA has terminated more than 50 lenders and placed another approximately 145 lenders on probationary lending status;

- **Enhanced lender monitoring activities**: Over the past three years, FHA has increased its lender monitoring staff more than sevenfold, from just 23 monitors in 1997, to more than 140 today. Similarly, FHA has dramatically increased the number of annual lender monitoring reviews from just 256 in FY1997, to more than 900 in FY1999;

- **Stepped-up lender enforcement actions**: The investment in increased monitor: g is beginning to pay off in the form of more lender enforcement actions. HUD's Mortgagee Review Board (MRB) imposed more than $1.7 million in civil money penalties on more than 30 lenders last year, and received indemnifications on a total of 1,025 loans, saving the Department an estimated $32 million in avoided losses – nearly as many indemnifications as the Department required over the preceding two years.

*b. FHA's Appraisal Reform Initiative*

Property flipping, the primary type of fraud encountered in Baltimore is most often associated with inflated or fraudulent appraisals. Therefore, our initiatives to safeguard the Fund began with the reform of the Federal Housing Administration's (FHA) appraisal process. Under the Homebuyer Protection Plan, FHA has developed the most comprehensive and thorough appraisal procedures in the housing finance marketplace today. Our reform package, which was developed during 1998 working in partnership with the Mortgage Bankers Association, the National Association of Realtors, the Appraisal Institute, the Appraisal Foundation and several consumer advocacy groups, is intended to provide the consumer with an unprecedented amount of information about the physical condition of the home they are purchasing, and also to create a more effective framework for FHA to hold appraisers accountable for their work. The initiative includes the following features:

- **Mandatory appraiser testing:** For the first time ever, all FHA appraisers will be required to pass an exam testing their knowledge of FHA appraisal requirements. This requirement was implemented on July 1, 1999, and is a mandatory requirement as of February 1, 2000;

- **A new, more thorough Valuation Condition (VC) form required for every FHA appraisal**: FHA is now the only mortgage finance organization in the country that requires every appraisal to include completion of a four page form that captures comprehensive information regarding the physical condition of the property. This form was made mandatory in all FHA appraisals as of September 13, 1999;

- **Homebuyer Summary Form**: FHA also is requiring lenders to provide every borrower with a summary of the results of the Valuation Condition form. This summary highlights any property physical conditions that do not meet HUD minimum property standards. This form also was made a mandatory component of all FHA appraisals as of September 13, 1999;

- **New Homebuyer Protection Form**: FHA now requires lenders to provide all borrowers this notice highlighting the importance of getting a home inspection. Implemented on September 13, 1999;

- **Enhanced appraiser enforcement processes and authority**: Working with the consulting firm Arthur Andersen, FHA also has developed a new method of using statistical indicators to target poor performing appraisers for extra monitoring activity. As part of this initiative, FHA also issued a new proposed federal regulation to clarify existing authority to pursue enforcement sanctions against fraudulent and poor performing appraisers in March, 2000.

Taken together, these reforms create the most effective safeguards against mortgage fraud – a well informed consumer and a clear and deliberate process for monitoring appraisers' work and pursing enforcement actions when warranted.

*c. Aggressive Foreclosure Avoidance*

In 1996 Congress authorized and FHA implemented a comprehensive new program of foreclosure avoidance, or loan loss mitigation, for FHA that protects the interest of borrowers and the financial integrity of the FHA Fund. This new program replaced the ineffective Assignment Program, which often left borrowers deeper in debt and was costly to the Fund. FHA's program includes a new comprehensive set of loan loss mitigation tools -- special forbearance periods, modification of loan payments, balance and/or interest rate, as well as pre-foreclosure sales to try to help borrowers in default avoid foreclosure and maintain ownership of their home. This broader set of tools addresses a far greater range of borrower problems than could be addressed through the Assignment Program. Perhaps most importantly, the Loss Mitigation Program shifts the emphasis to early intervention in the default cycle, when there is the greatest potential for the borrower to recover from default and remain in their home.

Through a combination of aggressive outreach and training for servicers, and tough monitoring and enforcement actions when necessary, FHA has grown this program substantially over the last three years. After assisting just approximately 5,800 borrowers in default in the first year of the program FY 1997, FHA assisted nearly 10,800 borrowers in FY 1998 and then more than doubled the program one year later when it assisted nearly 27,000 borrowers in FY1999. Moreover, more than 80 percent of all loss mitigation actions last year helped the borrower not only avoid foreclosure, but also maintain ownership of their home through a special forbearance, mortgage modification or a partial payment of claim. So far this year, FHA has helped nearly 23,000 borrowers in default avoid foreclosure and keep their homes – a pace that could result in more than 32,000 actions by the end of the fiscal year.

**(2) FHA's Fraud Investigation in Baltimore City**

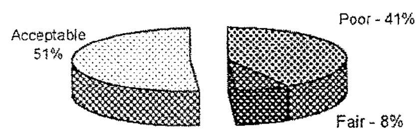
Expanding upon the ongoing fraud detection initiatives, HUD's Baltimore fraud investigation was focused on identifying fraud in three areas: First, were the overall underwriting guidelines met? Second, was there any lender fraud? Third, was there any appraisal fraud?

**a. Underwriting quality review.** To begin their search, HUD staff first intensively reviewed case files for all FHA borrowers that had been sent a notice of intent to foreclose between January 1, and March 30, 2000. These target loans were identified and collected in cooperation with St. Ambrose Housing of Baltimore City. In reviewing cases, FHA prioritized loans that were originated since 1997. Defaults on these relatively recent loans are most likely to be due to poor or fraudulent underwriting practices. By comparison, older loans are more likely to go to default due to serious illness, loss of employment or other borrower-related circumstances.

In total, 264 FHA-insured mortgages that had been originated subsequent to January 1, 1997 were targeted for review. Credit policy specialists then performed a detailed underwriting analysis of each case to determine whether overall underwriting guidelines were met relative to income, assets, employment, down payment, ratios, etc. Of the 264 properties under investigation, 53 FHA-approved lenders were involved in their origination. To date, approximately 90% of the case reviews have been completed by the lender monitoring team. It is anticipated that the remainder of the reviews will be completed prior to July 15, 2000.

Desk reviews are performed by evaluating the Uniform Residential Loan Application and information found in the FHA endorsement binder. The review does not include a physical inspection of the property. Of the 264 desk underwriting reviews completed by the Philadelphia HOC, 20 cases were rated "Fair" and 109 cases were rated "Poor" (see Chart 1). Both fair and poor ratings are considered unacceptable in FHA's underwriting standards.

Chart 1: Mortgage Credit Desk Review




**b. Lender Quality Review.** The desk reviews augment the lender monitoring reviews conducted by the Quality Assurance Division and help FHA determine the actions to be taken against lenders found to be in violation of FHA underwriting and processing guidelines. The underwriting desk reviews allow for targeting of individual lenders for referral to the Quality Assurance Division for further review and analysis. The HOC Quality Assurance Division is responsible for monitoring the origination activities and the proper application of HUD guidelines for all FHA-insured lenders.

Following the underwriting desk reviews, a team of FHA lender monitors did a second level review of all loans, specifically looking for evidence of fraud or predatory practices. This review included identification of falsified documents and possible property flipping. Additionally, for the first time, lender monitors utilized two automated databases of court house records showing prior sales of property in order to detect those properties that have had multiple repeat sales. This property sale analysis provides clear indications of property flipping schemes. For 53 properties, the deed was transferred at least twice within a twelve month period, with a significant increase in the sales price each time.

In order to establish trends and patterns within the pool of loans, FHA also created a database to analyze specific data elements from each case. These data elements included: loan officer/originator, date of loan closing, listing realtor, selling realtor, credit reporting source, closing agent, employer, how employment is verified (VOE form or alternate documents), automated underwriting usage, source of funds to close (gifts or other sources, including Nehemiah), local government closing assistance, and use of pre-purchase counseling. The database revealed more information about lenders including the following:

- 58% of the loans in foreclosure were financed by six lenders, with one lender responsible for 18% of the loans;
- 43% of the borrowers received gift funds of some kind;
- 16% of the borrowers were charged more than three points;
- Six properties to date have been verified as property flips and FHA will be demanding that the originating lender pay down the mortgage to the fair market value;
- In 3 of the 6 anticipated cram downs (140% overvalued), the same lender provided financing;

**Results:** As of a result of the reviews completed so far, the FHA will be making four Mortgagee Review Board referrals, recommending two suspensions or debarments, and requiring numerous loan indemnifications. Suspensions and debarments refer to the removal of authority to participate in FHA programs for a period of time. All suspensions and debarments are processed by the Department's Enforcement Center. Indemnifications require lenders to assume responsibility for specific loans for a five year period. During that period if the loan goes to foreclosure, the lender is ineligible for insurance benefits and will assume all losses associated with that loan.

The Mortgagee Review Board assumes responsibility for lender offenses which demonstrate a systemic or company-wide problem. The four cases which are being referred to the Board represent new cases as well as the further expansion of existing cases.

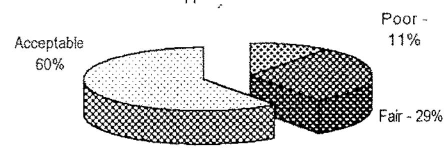
It is also anticipated that "cram down" letters will be sent to the lenders involved with the six properties identified to date as being overvalued by more than 140%. A cram down is the reduction of the amount of an existing mortgage to more accurately reflect the value of the property, and is meant to remove excessive principal debt substantiated by faulty appraising or loan practices.

In addition, a review committee has been established to discuss the disposition of each case in order to determine if additional administrative action is warranted. The results of the review committee's actions will be provided at a later date.

**c. Appraisal Quality Review**. Each of the 264 cases in question were also individually desk reviewed by HOC staff in order to determine the appraiser's adherence to FHA guidelines and to identify those cases in which fraud may have been committed. Desk appraisal reviews are performed using the documentation provided in the Uniform Residential Appraisal Review form and do not include a physical inspection of the property. The desk appraisal reviews identified 133 suspect appraisals, which were then submitted for a field appraisal review. Field appraisal reviews include a re-determination of property value, a determination of appropriate comparable properties, determination of appropriate property adjustments, and an on-site inspection of the property in question. As a result, 53 of the 133 appraisals were rated fair or poor by the contracted review appraiser (see Chart 2.)

The poor and fair ratings were based upon a variety of factors, including poor comparable property choices, incorrect or excessive property adjustments, missing or ignored valuation conditions, as well as evidence of fraud. In addition to the poor quality of appraisal methods and techniques in the group, this preliminary field review also determined that a total of 18 appraisals were overvalued.

Chart 2: Appraisal Field Reviews




HUD's database also revealed that 38% of the loans in foreclosure were appraised by five appraisers, with one appraiser responsible for 18 percent of the total. In addition, in 5 of the 6 anticipated cram downs, the same appraiser had conducted the appraisal.

**Results:** The preliminary field appraisal reviews were the basis for the issuance of notification of poor performance letters to 21 different FHA-approved appraisers who received "poor" ratings on their field reviews. These notifications require the appraiser to respond to the specific allegations of poor appraisal performance. A non-response to the letter will result in the loss of approval as an FHA appraiser. Ten responses have been received by the Homeownership Center, with the majority of responses disputing HOC findings. Based on the findings of the field reviewers, the Homeownership Center is currently evaluating appropriate enforcement actions potentially including appraiser removal, limited denials of participation, or suspensions for the appraisers involved.

The preliminary field review of appraisals provided by the HOC also allowed for the targeting of individual appraisers for referral to the Department's Real Estate Assessment Center (REAC). A total of 114 appraisals have been referred to REAC for their review and analysis. REAC works closely with mortgage lenders, appraisers, home inspectors and other industry partners to ensure that FHA mortgage holders have complete and accurate information about the condition and value of the homes they are purchasing. REAC staff determines appraisal quality through computer analysis and the scoring of all FHA appraisals submitted for endorsement and quality assurance review of appraisals with potential weaknesses. REAC is working closely with the Philadelphia HOC to complete field reviews on cases identified as flipped properties in order to refer them back to the HOC for administrative action. Thus far, REAC has identified eight cases which are overvalued, with the worst case being overvalued by 243%. Moreover, FHA anticipates more cases will be forthcoming.

(2) **FHA'S Efforts to Help Families Avoid Foreclosure**

The second focus of the SWAT Team was to pursue an aggressive strategy to help defaulting Baltimore homeowners avoid foreclosure. To do this, FHA attempted to contact all borrowers with impending foreclosures to try to put them into one of FHA's foreclosure avoidance actions. HUD also trained the 11 HUD approved Housing Counseling Agencies in the Baltimore City area on default servicing and loss mitigation techniques. Finally, FHA contacted the corresponding lender for each case to ensure that they were properly evaluating borrowers and offering appropriate foreclosure avoidance options.

**a. Mortgagor Communication.** In the first stage of its process, NSLMC contacted each mortgagor, by phone and letter, to establish the level of mortgagor understanding of available loss mitigation options, whether the mortgagor had been contacted to discuss possible loss mitigation options, and to determine if the borrowers were aware of the counseling available to them through HUD approved Housing Counseling Agencies. This process also served to uncover other indications of predatory lending.

**b. Housing Counseling Training.** For six weeks following the implementation of the moratorium NSLMC staff conducted default servicing and loss mitigation training to the 11 HUD approved Housing Counseling Agencies in the Baltimore City area. Further dialogue occurred between community builders, local officials and others on how HUD can better support the borrower by guiding them to appropriate support groups.

**c. Servicing Mortgagee Communication.** NSLMC contacted 53 servicing mortgagees to gather general loan information, servicing and payment histories so that NSLMC could evaluate the mortgagee's compliance with FHA loss mitigation regulations.

**Results:** Overall, NSLMC found that many of the borrowers did not qualify for loss mitigation assistance because the property was already in the advanced stages of the foreclosure process. NSLMC consistently discovered that the Housing Counseling Agencies (HCA) had not played a role in offering guidance to the borrowers as HUD had anticipated. The HCAs indicated that they are typically understaffed and under-funded.

Fifty-eight of the 319 total loans (18%) reviewed in depth had loss mitigation violations. Approximately one half of those violations represented cases where no loss mitigation evaluation had occurred at all, 17% of the violations had inadequate loss mitigation efforts performed and 31% of the violations did not have sufficient documentation supplied to properly evaluate loss mitigation efforts.

The National Servicing And Loss Mitigation Center will generate letters notifying the lenders/servicers of servicing and loss mitigation violations. The lenders/servicers are allowed 10 business days from the date of the letter to respond. If the lenders/servicers' reply does not satisfy the request, a Notification of Violation Referral is forwarded to the Quality Assurance Division advising them to target these lenders/servicers for a comprehensive servicing monitoring review.

Four loans have been referred to the Philadelphia Home Ownership Center as possible predatory lending concerns because of over valuation or inflated borrower income.

NSLMC has provided additional outreach and training to lenders/servicers, who service loans in the Baltimore area, on performing proactive, aggressive and early intervention loss mitigation efforts. This was accomplished by citing 14 lenders/servicers for a variety of violations associated with servicing and loss mitigation, and affording them the opportunity to take corrective action. Additionally, NSLMC has extended a special invitation to these 14 lenders/servicers to attend training in Oklahoma City. Five of the fourteen violators attended training in June and additional dates have been set for July, August, and September for others to attend.

In addition, more than one dozen servicers are being cited for failure to properly perform foreclosure avoidance. Depending on the severity of the deficiency, these servicers may receive penalties ranging from civil money fines, to possible suspension and debarment from FHA programs.

Finally housing counseling agencies in the Baltimore area recognize the need to become proactively involved in the predatory lending and loss mitigation issues within their community. NSLMC supported these HCA efforts by detailing staff to provide loss mitigation training to 11 HUD approved Housing Counseling Agencies. NSLMC continues to further support these HCAs on any individual cases that the HCAs might be experiencing difficulty with.

## B. FHA FRAUD PREVENTION PLAN: PROTECTING FHA HOMEOWNERS FROM PREDATORY LENDING

Working with the Baltimore Task Force and informed by many of the above suggestions from community advocates, FHA also developed a series of new initiatives to address predatory practices targeted at FHA and its borrowers, including inflated appraisals, fraudulent underwriting, property flipping and other lending abuses.

FHA's reforms to protect homeowners from predatory lending focus on two main areas: (1) providing relief to those FHA borrowers already in distress, especially those who have been victimized by abusive lending practices; and, (2) strengthening FHA endorsement and fraud detection procedures to prevent predatory practices from occurring in the first place. The new reforms build on existing FHA efforts to streamline operations and eliminate abusive practices including Credit Watch, the Homebuyer Protection Plan, and a variety of reforms of the FHA property disposition program including the new Marketing and Management Contractors, the Good Neighbor Sales Program, and the Teacher and Officer Next Door Programs. As described more fully in Appendix C, these initiatives will be tested first in Baltimore and then rolled out nationally.

FHA agrees that there is a significant need for greater public education as well as individual counseling. To assist victims of predatory lending, FHA proposes to fund extensive foreclosure avoidance counseling for FHA homeowners in default. By creating a new funding source for default counseling, FHA will expand the availability and improve the quality of counseling. This will help homeowners make better use of currently available foreclosure prevention tools such as mortgage modification, and partial loan forgiveness. These efforts, commonly referred to by lenders as loss mitigation tools, have one simple goal: to help FHA borrowers stay in their homes.

For those borrowers saddled with inflated mortgages that stem from appraisal abuse, FHA will direct mortgage lenders to write down the mortgage to a level consistent with a fair market appraisal. In situations where the lender refuses to honor this demand, FHA will intervene, cancel the existing mortgage and refinance the mortgage at the fair market value. In addition, FHA will instruct lenders to issue a "credit repair" letter to ensure that the victim's credit record is set straight.

Victim relief is just one important step in addressing the problem of FHA foreclosures in Baltimore: the next challenge is to stop predatory practices from undermining the ability of FHA to promote housing opportunity. Once again building on the initial results of the Baltimore laboratory, FHA will institute an automated system to review the sales price history of properties prior to approval of FHA insurance. This new system will identify and stop abusive appraisal practices before the loan is endorsed.

Community advocates involved in the Task Force pointed out that at least two-types of neighborhoods are involved in the FHA-insured mortgage market. In "first tier" neighborhoods, most loans are successful, default rates are low and stable homeownership contributes to a stable community. In "second tier" neighborhoods, high default rates create a unstable community. In a variation on the advocate's recommendation of a two-tiered response to this divergence, FHA will form a variety of "SWAT" teams, modeled on the Baltimore team, to target abusive appraisal practices in areas with a high concentration of FHA foreclosures. Finally, FHA is launching a new Appraisal Watch System, similar to the Credit Watch system now targeted to lenders, to identify appraisers with a record of faulty appraisals and abusive practices, terminate them from FHA programs, and, if appropriate, pursue legal action.

**(1) Helping Victims Avoid Foreclosure and Retain Their Home**

Although the goal of FHA's reform initiatives is to prevent predatory lending practices from occurring in the first place, FHA also is developing a full array of tools to help those borrowers who already have been victimized to avoid foreclosure, retain their home with a reasonable level of debt and, if necessary, repair their credit. New initiatives to help the victims of predatory lending include:

**Counseling Borrowers in Default.** HUD's network of more than 1,200 approved counseling agencies nationwide help thousands of families every year make well-informed home purchase decisions. But the availability of counseling services is uneven across geographic areas, and there are far too few agencies with the capacity to provide specialized foreclosure avoidance counseling to borrowers in default. Therefore, FHA is launching a new initiative to directly fund default counseling in select "Hot Zones". Through this program, FHA will offer borrowers in default a voucher for counseling services, redeemable at their local HUD-approved counseling agency. Once completed, the counseling provider agency can redeem the voucher with HUD to receive payment. As an eligible FHA foreclosure avoidance effort, this initiative will be funded from FHA's mortgage insurance fund.

**Restructuring Inflated Mortgages.** Once FHA identifies a mortgage based on a fraudulent appraisal, FHA will move to force the lender to write the mortgage down to a level consistent with true market value. If needed, the family will be provided a 203k purchase rehab loan to fund the cost of needed repair. In the case of a recalcitrant lender, FHA loss mitigation specialists will intervene directly, cancel the insurance, take possession of the deed, and resell the property with FHA insurance to the family for the fair market price.

**Repairing Credit of Abused Borrowers.** In cases of default or foreclosure linked to fraudulent appraisals or underwriting, FHA will instruct the lender to issue a "credit repair letter" to the borrower and notify the credit reporting agencies of this action.

**Approving New Software to Empower Default Counselors.** Working in cooperation with national venders, FHA has developed guidance on new computer software which assists default counselors in examining FHA foreclosure avoidance options and advising clients as to the best course of action. The first software package approved for use under this new initiative, "BackInTheBlack" loss mitigation application, was developed by a Baltimore based company, and is available free of charge to local housing counseling agencies. FHA is also currently reviewing additional software programs at the request of other developers. FHA is pleased to participate in the development of these foreclosure avoidance software packages which, when used properly, promote effective early response and appropriate use of FHA's foreclosure avoidance actions.

**Focusing Resources on Loss Mitigation Assistance.** In "Hot Zone" areas with high default and foreclosure rates, FHA will establish teams of loss mitigation specialists to work with lenders and borrowers to ensure that every effort is made to help families remain in their homes.

**(2) Protecting FHA Homeowners From Predatory Lending**

FHA's new preventive measures include initiatives designed to: (1) strengthen FHA loan endorsement policies and procedures; and, (2) enhance FHA's ability to identify and discipline perpetrators of fraud and predatory lending practices.

**a. Initiatives to Strengthen FHA Endorsement Policies and Procedures**

**Identifying Flipped Properties Prior to Loan Endorsement.** One of the most prevalent predatory practices among some FHA lenders in Baltimore is financing property flips. This occurs when a property is purchased by an investor for a relatively low price then quickly resold, or flipped, to an unsuspecting purchaser for a much higher, inflated price with little or no improvements to the property. With an inflated appraisal and loan amount, the ultimate purchaser pays too much for their home and is set up for failure. To prevent this practice, FHA will use newly available data on prior homes sales to check each application for FHA insurance and determine if the requested mortgage amount is consistent with the property's previous sales price history. Those cases evidencing property flipping will be denied FHA insurance, pending further investigation. As part of this initiative, FHA also will monitor future applications for FHA insurance to prevent former FHA REO foreclosed properties from being flipped and returned to the portfolio at an inflated price.

**Restricting Loan Points and Fees.** The Baltimore Task Force identified some cases in which FHA borrowers were charged unreasonably high points and fees, as is the case with many subprime loans. Given that FHA provides 100 percent insurance coverage and that FHA loans have simple, uniform terms, the costs associated with making an FHA loan should be comparable to other conventional loans. Therefore, FHA will impose a cap on the total amount of points and fees charged FHA borrowers

**Tightening Use of Gifts for Downpayment.** The Baltimore Task Force identified the fraudulent use of gift letters as another practice used by unscrupulous lenders to qualify borrowers for inflated mortgages. FHA will release new and clearer guidance designed to tighten controls on FHA gift letters and enhance monitoring of these provisions.

**b. Initiatives to Identify and Discipline Perpetrators of Fraud and Predatory Practices**

**Using "SWAT" Teams to Identify Unscrupulous Appraisers and Predatory Lenders in Hot Zones.** In Baltimore, FHA sent a SWAT team to review all foreclosures taking place from January through March of 2000. Based on this review, FHA identified a number of apparently fraudulent practices on the part of FHA appraisers and lenders. These individuals and firms will be referred to FHA's Quality Assurance Division for further action, and if appropriate, to HUD's Enforcement Center or Office of Inspector General. By immediately stopping such bad actors in their tracks, communities can begin to recover. HUD plans to immediately extend the SWAT team approach to assess potential fraudulent activities in other cities now experiencing high numbers of FHA defaults and foreclosure

**Implementing Credit Watch for Appraisers.** The Baltimore Task Force identified fraudulent appraisals as a key contributor to subsequent default and foreclosure. FHA is currently implementing a new automated appraisal review system. To increase the effectiveness of this system, and building on the Credit Watch for Lenders, FHA will create a Credit Watch System for Appraisers that will rate appraisers on the performance of the loans linked to their appraisals. Appraisers with a consistent pattern of participating in loans that quickly move to foreclosure will be targeted for further review and, if appropriate, removed from the FHA Appraisal Roster. Like FHA's Credit Watch for Lenders, this new system will allow FHA to discipline appraisers simply based on poor performance.

Similarly, lenders associated with poorly performing appraisers will be targeted for further review and action. Finally, FHA is releasing a list of the appraisers associated with FHA foreclosed loans reviewed by the Baltimore Task Force (See Appendix B for a list of appraisers and lenders associated with loans reviewed by the Task Force). This summary shows that just five individual appraisers were responsible for the appraisals on nearly 40 percent of all FHA foreclosures in Baltimore City that occurred between January and March, 2000, and were underwritten within the last three years. Likewise, only five lenders accounted for almost 50 percent of all FHA foreclosures in the same period.

**Tracking Mortgage Brokers.** Today FHA electronically identifies the lender, the appraiser, and the non-profit entity (if any) involved in making an FHA loan. With a growing number of FHA-insured loans originating with the significant involvement of mortgage brokers, the Department believes it must also develop the capacity to monitor loan performance by individual mortgage brokers. To further enhance oversight of the underwriting process, FHA will require that the Tax Identification of any Mortgage Broker participating in the transaction be recorded as well. This new information will give FHA, for the first time, the capacity to monitor broker performance and target for disciplinary action those associated with a high loan default and claim rate.

**Suspending Abusive Brokers.** Through listing of properties on Multiple Listing Services (MLS) and the Internet, FHA's new management and marketing procedures have streamlined the sale of FHA foreclosed properties and expanded the number of participating real estate agents. Working with the Baltimore Task force, FHA will review the list of participating real estate brokers and terminate unscrupulous brokers from future participation in FHA programs.

**Early Warning Indicators.** FHA will customize data from its Neighborhood Watch system to develop early warning indicators of emerging foreclosure "Hot Zones." This data will enable local officials and HUD approved counseling organizations to better target outreach to families at risk of foreclosure. FHA will also make available summaries of the appraised values of FHA properties to help local officials better assess real estate trends and spot possible patterns of appraisal abuse. This public information will include performance data on individual appraisers generated by the Credit Watch for Appraisers system and posted on the HUD website.

## C. HUD's LEGISLATIVE AGENDA

**(1) Credit Watch Termination Codification**: The National Housing Act requires HUD to operate the FHA Mutual Mortgage Insurance Fund (which backs the majority of FHA-insured single family mortgages) in an actuarially sound manner. To accomplish this, FHA needs the ability to stop doing business quickly with a mortgagee whose high level of early defaults and claims presents an unacceptable risk to the insurance fund.

Accordingly, FHA is proposing to amend section 533 of the National Housing Act to confirm the Department's existing authority to terminate the mortgagee approval when the mortgagee has an unacceptably high level of early defaults and claims for such mortgages in the area covered by a HUD field office, in comparison to other mortgagees lending in the same area. This would not affect a mortgagee's ability to continue to service, hold, or invest in FHA-insured mortgages.

FHA's termination regulation supplements, and performs a different purpose than, the regulations of the Mortgagee Review Board (MRB). The MRB is the only entity with authority to withdraw FHA approval from a mortgagee completely and, in essence, stop the mortgagee from doing any further business with FHA. The MRB takes this action if FHA proves that the mortgagee has engaged in fraudulent or other significantly deficient practices. This procedure does not address the situation of a demonstrably poor performer that has not engaged in provable violations or fraud.

If FHA is to operate in a more efficient and business-like manner, it needs to focus on outcome and performance, not process. Mortgagees whose loans perform so poorly that many default in their early months present a clearly unacceptable risk to the FHA insurance fund that, ultimately, may impair FHA's ability to continue to serve the low- and moderate-income borrowers who depend on FHA. FHA needs to continue to have a business mechanism to prevent these mortgagees from originating or underwriting new FHA-insured loans (and consequently from increasing the risks to the insurance funds and affecting FHA's ability to serve borrowers) without having to prove that the mortgagee is engaging in fraud or other irregularities. This proposed legislation would provide a more explicit statutory foundation for such a mechanism.

Despite the fact that FHA has clear, general statutory authority to administer the Credit Watch Termination program, two Baltimore area lenders have been successful in fighting proposed termination of their authority to originate FHA-insured loans in the Baltimore Federal District Court. HUD along with the Department of Justice (DOJ) is appealing both of these adverse decisions. To date, FHA has successfully terminated approximately fifty lenders trough the Credit Watch Termination program, with just these two Baltimore cases, brought by Capitol Mortgage and American Skycorp Mortgage, successfully fighting termination in court. Still, the Department seeks a legislative amendment to Section 533 of the National Housing Act, to more clearly codify the Credit Watch Termination program into HUD's statutory authority. This proposed amendment would mitigate the likelihood of future successful litigation against the Department.

(2) **Expansion of HUD's Authority to Make Purchase Money Mortgages**: As noted earlier, once FHA identifies a mortgage based on a fraudulent appraisal, FHA will move to force the lender to write the mortgage down to a level consistent with true market value. In the case of a recalcitrant lender, FHA will intervene directly, cancel the insurance, take possession of the deed, and resell the property with FHA insurance to the family for the fair market price. FHA anticipates that in most instances, these sales will be completed in partnership with an FHA approved lender who will make the take-out loan. At the same time and in order to expand HUD's ability to play an active role in structuring FHA-insured loans, the Department seeks broader authority to make direct purchase money mortgages to victims of fraudulent, inflated appraisals. HUD currently has clear authority to originate purchase money mortgages to finance the purchase of HUD homes by local governments and nonprofit community based organization. This proposal would allow HUD to directly fund loans to individual victims, and provide an additional avenue for victim relief.

**(3) Provide HUD with Authority to Issue Grants for Neighborhood Initiatives Targeted to Foreclosure Avoidance or More Expeditious .** As noted, HUD has the authority to use the Mutual Mortgage Insurance (MMI) Fund to pay expenses related to the disposition of HUD foreclosed properties, as well as for a variety of foreclosure avoidance efforts including partial payments of claim and pre-foreclosure counseling. At the same time, FHA is precluded from using MMI Funds to issue direct grants to community-based organizations to conduct a wide range of neighborhood initiatives targeted at foreclosure avoidance or to assist in the disposition of HUD foreclosed properties. As outlined earlier, such initiatives could range from enhanced pre-purchase counseling, to additional monitoring of FHA appraisals and underwriting or expanded involvement in the disposition of HUD foreclosed properties. To date, such activities have been funded either from the annual appropriation for HUD counseling agencies, or from a limited pool of special purpose grant dollars. Providing HUD with the authority to utilize MMI Funds for a wider range of activities would greatly increase HUD's capacity to work in partnership with community-based organizations to shape appropriate local foreclosure avoidance strategies.

IV. **Baltimore Responds**

In recognition of the fraudulent real estate practices that have occurred in the Baltimore City real estate market over the past several years, the City of Baltimore acting by and through the Department of Housing and Community Development has placed in effect the following policies and procedures. These procedures are designed to afford the prospective buyers of properties in Baltimore the opportunity to receive fair consideration in receiving City home buyer assistance with the least opportunity for fraud and over charging by lenders and mortgage brokers.

**A. Lender Qualifications:** As a participating lender in City sponsored home buyer assistance programs, lenders must meet the following requirements:

- Maintain an office in the Baltimore Metropolitan area where customer applications are originated in face to face interviews,
- Be qualified and approved to sell mortgages to and service mortgages for the Federal National Mortgage Association (FNMA) or the Federal Home Loan Mortgage Corporation (Freddie Mac),
- Be approved by Federal Housing Administration (FHA) as a direct endorsement lender,
- Be a member of or subject to regulation by the Federal Savings and Loan Insurance Corporation, the Federal Deposit Insurance Corporation or National Credit Union Administration or any successor of the foregoing,
- Be subject to underwriting qualifying ratio limits, caps on lender fees and discount points charged to the borrower which ultimately are paid from City sponsored home buyer programs,
- Where fees and points are excessive, borrowers would be required to receive home ownership counseling prior to reconsideration of the assistance application.
- Lenders in the City Settlement Expense Loan Program are currently subject to termination when default and delinquency rates reach 10% of the SELP portfolio they have originated.

**B: Public Education:** Public education efforts to inform the public on the prevention of fraudulent real estate practices.

- Joint public education campaign through the media and direct mail advising prospective home buyers to seek counseling before purchase by contacting hot line phone number to talk with a counselor or real estate professional.
- Training seminars with the real estate trade organizations to educate agents and brokers on identifying the fraud transaction and providing resource referrals for buyers who suspect fraud.
- Continued promotion and education with the Housing Counselor network through the Maryland Center for Community Development.
- Use of approved housing counselors, non-profit community development corporations, and lenders in City sponsored home buyer campaigns, i.e. Buy Into Baltimore Trolley Tours of neighborhoods.
- Posting of only approved lenders on the www.livebaltimore.com web site for access by the public including list of approved housing counselors.

V. **Law Enforcement Responds**

On March 27, 2000 United States Senator Barbara Mikulski held a hearing of the Senate Appropriations Subcommittee for VA-HUD and Independent Agencies. Federal law enforcement agencies testified about coordinated efforts of an investigative task force. Over 25 investigators, auditors, and prosecutors are involved from the FBI, the IRS, the U.S. Postal Inspector's Office, the HUD Inspector General's Office, and the Office of the U.S. Attorney. In the FBI alone, there are over 20 active investigations. Thus far this year, three sets of indictments have been handed down by federal grand juries. Mortgage originators, appraisers, lawyers, and other professionals who allegedly collude in the commission of mortgage scams and flipping schemes have been charged. Senator Mikulski summed up the message from the federal law enforcement community to flippers and scammers, "we're coming after you!"

Members of the Baltimore Task Force are assisting law enforcement agencies in a variety of ways. We have met with federal investigators regarding specific cases and to discuss dysfunctional aspects of Baltimore's housing market more generally. The research conducted by HUD and FHA, with assistance from local non-profit agencies, has revealed suspicious patterns of sales, appraisals, foreclosure rates, and potential fraud; this research is being shared with law enforcement authorities. We look forward to the deterrent effect that successful prosecutions and stiff sentences will have on the perpetrators of housing fraud.

## VI. NEXT STEPS

As the Task Force itself winds down, much work remains to be done in Baltimore to follow through with the excellent progress made over the last two months. Two priorities for Baltimore are addressing neighborhood recovery for those communities hardest hit by flipping and a legislative agenda to prevent mortgage fraud. Baltimore City's Department of Housing and Community Development has been working closely with Task Force members and other community leaders to develop a recovery strategy for Baltimore. The key elements of the recovery strategy are contained in a proposal that will be submitted to HUD to access Neighborhood Initiative Program funds. The outline of the proposal is below.

**A. Neighborhood Initiative Program.** Baltimore City's Department of Housing and Community Development (DHCD) is requesting HUD Neighborhood Initiative Program funding to implement comprehensive neighborhood redevelopment strategies in Baltimore's transition neighborhoods. In the last five years, Baltimore has been severely impacted by mortgage foreclosures and flipping scams. At the present time we estimate that there are over 1,100 FHA foreclosed properties sitting vacant in Baltimore City. Many of the foreclosures, both FHA and other, resulted in vacant, dilapidated buildings. These vacant buildings caused blight and destabilization in many of Baltimore's older communities that were already suffering from economic and social change. In order to improve the transition neighborhoods in Baltimore, DHCD proposes a three-pronged strategy: (1) a Healthy Neighborhoods initiative (2) a Stabilization and Recovery initiative; and (3) the creation of a Clearinghouse for flipping victims.

**(1) Healthy Neighborhoods.** In the Fall of 2000, Baltimore City's DHCD will begin a new initiative called "Healthy Neighborhoods." The initiative is a public-private collaborative among DHCD, the State of Maryland, the Baltimore Community Foundation and local banks to strategically provide positive neighborhood-directed investment to improve transition neighborhoods. DHCD is funding the initiative with one million dollars from the State as a pilot program. DHCD would like to use Neighborhood Initiative Program money to enhance the Healthy Neighborhoods initiative.

The Healthy Neighborhoods initiative will succeed by making available financial resources, training, and technical assistance to four or five selected neighborhoods. These resources will be used to implement an innovative program of lending, neighborhood pride projects, along with outreach and marketing tailored to each neighborhood's needs. The program and its resource commitments are intended to expand and reinvigorate neighborhood involvement and homeowner investment in communities throughout Baltimore. Attention must be paid to these neighborhoods so that they become healthy again and are places that people want to live. Some of the specific approaches that will be utilized in the pilot neighborhoods will include:

- low-interest incentive financing to promote homeownership
- training and technical assistance to neighborhoods
- maintenance and improvement of homes and open space
- support for self-help neighborhood projects
- operating support for organizations carrying out the work in target neighborhoods

- expanding neighborhood pride and neighborliness through involvement of residents in neighborhood promotion and pride projects.

Examples of transition neighborhoods in Baltimore include Patterson Park, Belair-Edison and Garwyn Oaks. These neighborhoods contain significant concentrations of HUD-owned properties. Financial assistance will enable rehabilitation of these and other vacant properties. Homeownership opportunities, combined with other neighborhood support initiatives, will provide the comprehensive attention necessary to make these transition neighborhoods healthy again.

**(2) Stabilization and Recovery.** Within the category of transitional neighborhoods in Baltimore, there are some neighborhoods that have suffered the greatest impact from FHA foreclosures, mortgage fraud, and related disinvestment. These neighborhoods now have a substantial number of vacant houses that have a blighting effect. In the short-term, due to the weakness in the housing market in these areas, few of these vacant houses will be rehabilitated. Therefore, in addition to homeownership incentives, these neighborhoods need the capacity to maintain vacant houses and make other improvements to ensure their ultimate long-term recovery.

DHCD proposes targeting two to three neighborhoods in Baltimore that have been severely impacted by foreclosures and related disinvestment. DHCD will provide these communities with funding available to stabilize and maintain vacant properties. This essential ability is lacking in almost all distressed neighborhoods in Baltimore. We propose that this function be handled at the neighborhood level. Community-based organizations can respond more quickly than HUD or the City of Baltimore to problem trash or physical conditions of properties. Stabilizing roofs and other parts of vacant buildings is essential to ensuring their ultimate productive reuse. DHCD will also provide funding for other neighborhood support strategies identified by the target communities. These strategies could include community organizing, housing counseling, home improvement programs, and other community development.

This stabilization and recovery initiative will minimize the negative effects of vacant houses on transition neighborhoods and cultivate the conditions necessary for healthy and safe neighborhoods.

**3. Clearinghouse For Mortgage Fraud Victims.** Advocacy groups estimate that the number of flipping and mortgage fraud victims in Baltimore is in the thousands. Victims face the loss of their homes, ruined credit, harassment by lenders, and bankruptcy. Currently, there is no one place to turn in Baltimore if you are a mortgage fraud victim. While many non-profits and government agencies can help with pieces of the relief available, comprehensive assistance is not available.

DHCD proposes establishing a Clearinghouse for victims of mortgage fraud in Baltimore. This Clearinghouse will include the following components:

- counseling staff knowledgeable in all resources available to victims
- legal staff able to pursue legal remedies or refer to appropriate State and Federal legal authorities
- public education materials and outreach campaign
- coordination with FHA to utilize new tools made available to victims
- coordination with DHCD regarding housing assistance
- continuing data collection regarding foreclosure and fraud trends in Baltimore

The Clearinghouse will provide an effective and much-needed link between HUD and the victim community. Victims will be assisted in a comprehensive manner.

**(4) Budget**

**HUD**

| | |
|---|---|
| FY 2000 | |
| Healthy Neighborhoods | $1,500,000 |
| Stabilization and Recovery | $ 750,000 |
| Clearinghouse | $ 250,000 |
| FY2001 | |
| Healthy Neighborhoods | $1,500,000 |
| Stabilization and Recovery | $ 750,000 |
| Clearinghouse | $ 250,000 |
| Total over two years | $5,000,000 |

**Baltimore City/ State of Maryland Match:**

| | |
|---|---|
| FY 2000 (funding secured) | $1,000,000 |
| FY2001 (funding to be sought from State) | $5,000,000 |
| Total over two years | $6,000,000 |

In addition to the initiatives outlined in the Neighborhood Initiative Program proposal, Baltimore Task Force members will work over the next six months to develop a legislative agenda for the next Maryland legislative session that begins in January 2001. Task Force member Delegate Carolyn Krysiak has been a leader on mortgage fraud legislation and will be spearheading our efforts.

## Appendix A: Task Force Members

Patricia J. Payne, Commissioner, Baltimore City Department of Housing and Community Development

Denise Duval, Deputy Commissioner, Baltimore City Department of Housing and Community Development

Vincent Quayle, Director, St. Ambrose Housing Aid Center

Ed Rutkowski, Director, Patterson Park Community Development Corporation

Kenneth Strong, Director, Southeast Community Organization/Southeast Development Incorporated (SECO/SDI)

Garrard Johnson, Director, Govans Economic Management Senate

Carolyn Krysiak, Maryland General Assembly

Lavinia Alexander, Circuit Court of Baltimore City

Andre Weitzman, attorney

Barbara Aylesworth, Belair-Edison

Michelle Moore, ACORN

Mitchell Klein, ACORN

Denis Murphy, Civil Justice, Inc.

John Netheront, Maryland Attorney General's Office

**HUD TASK FORCE PARTICIPANTS**

William Apgar, Assistant Secretary for Housing - Federal Housing Commissioner

Cardell Cooper, Assistant Secretary for Community Planning and Development

Nancy Lesser, Senior Counselor to the Secretary

Elinor Bacon, Deputy Assistant Secretary for Public Housing Investments

Harold Young, Senior Community Builder, Maryland State Office

Engram Lloyd, Director, Philadelphia Homeownership Center

Matt Franklin, Associate General Deputy to the Assistant Secretary for Housing - Federal Housing Commissioner

Bill Rudy, Special Assistant to the Assistant Secretary for Community Planning and Development

**Appendix B: FHA Foreclosure Actions**
January 1, 1997 - Present

| Top 5 Appraisers | Number of Foreclosures |
|---|---|
| 1. Dale Schulz | 34 |
| 2. Sean C. Jones | 10 |
| 3. Spencer T. Vaughn | 10 |
| 4. Kenneth Robinson | 9 |
| 5. Marc I. Tilles | 9 |
| | 72 out of a total 198 = 36% |

| Top 5 Lenders | Number of Foreclosures |
|---|---|
| 1. Capital Mortgage Bankers, Inc. | 37 |
| 2. Harbor Financial Mortgage Corp. | 17 |
| 3. First Mariner Bank | 17 |
| 4. American Skycorp, Inc. | 13 |
| 5. First Horizon Home Loan Corporation | 11 |
| | 95 out of a total 198 = 48% |

## Appendix C: Implementation Timeline for HUD's Response

### Timeline for FHA Initiatives to Help Victims Avoid Foreclosure and Retain Their Home

**a. Counseling Borrowers in Default.** FHA will launch a new initiative to directly fund default counseling in select "Hot Zones". Through this program, FHA will offer borrowers in default a voucher for counseling services, redeemable at their local HUD-approved counseling agency.

**Implementation Timeline:**

| | |
|---|---|
| ♦ Launch pilot in Hot Zone cities | August 1, 2000 |
| ♦ Assess pilot results and determine national implementation strategy | September 30, 2000 |

**b. Restructuring Inflated Mortgages.** Once FHA identifies a mortgage based on a fraudulent appraisal, FHA will move to force the lender to write the mortgage down to a level consistent with true market value. In the case of a recalcitrant lender, FHA loss mitigation specialists will intervene directly, cancel the insurance, take possession of the deed, and resell the property with FHA insurance to the family for the fair market price.

**Implementation Timeline:**.

| | |
|---|---|
| ♦ Complete draft demand letters to originators/,servicers | June 15, 2000 |
| ♦ Complete draft program design | June 15, 2000 |
| ♦ Finalize demand letters | June 30, 2000 |
| ♦ Finalize program design | June 30, 2000 |
| ♦ Issue first set of demand letters to compensate Balt. victims | June 30, 2000 |
| ♦ Expand program to other Hot Zone cities | August 15, 2000 |
| ♦ Roll out national program | September 30, 2000 |

**c. Repairing Credit of Abused Borrowers.** In cases of default or foreclosure linked to fraudulent appraisals or underwriting, FHA will instruct the lender to issue a "credit repair letter" to the borrower and notify the credit reporting agencies of this action.

**Implementation Timeline:**

| | |
|---|---|
| ♦ Complete draft credit repair letter | June 15, 200 |
| ♦ Finalize credit repair letter | June 30, 2000 |
| ♦ Issue first credit repair letters | June 30, 2000 |

**d. Approving New Software to Empower Default Counselors.** FHA has developed guidance on new computer software which assists default counselors in examining FHA foreclosure avoidance options and advising clients as to the best course of action. The first software package approved for use under this initiative is available free of charge to housing counseling agencies. FHA is also currently reviewing additional software programs at the request of other developers.

**Implementation Timeline:** FHA already has approved one software package, and has a few others currently under review. Future reviews will be ongoing.

**e. Focusing Resources on Loss Mitigation Assistance.** In "Hot Zone" areas with high default and foreclosure rates, FHA will establish teams of loss mitigation specialists to work with lenders and borrowers to ensure that every effort is made to help families remain in their homes.

**Implementation Timeline:**

| | |
|---|---|
| ♦ Designate new Hot Zones | July 17, 2000 |
| ♦ Launch focused loss mitigation review in new areas | August 15, 2000 |

**Timeline for FHA Initiatives to Protecting FHA Homeowners From Predatory Lending**

**a. Identifying Flipped Properties Prior to Loan Endorsement.** To prevent property flipping FHA will use newly available data on prior homes sales to check each application for FHA insurance and determine if the requested mortgage amount is consistent with the property's previous sales price history. Those cases evidencing property flipping will be denied FHA insurance, pending further investigation.

**Implementation Timeline:**

| | |
|---|---|
| ♦ Pilot software on all loans endorsed in Baltimore City | June 8, 2000 |
| ♦ Select national software contractor | July 10, 2000 |
| ♦ Issue Report on findings of Baltimore City pilot | July 30, 2000 |
| ♦ Implement in other Hot Zone areas | August 1, 2000 |
| ♦ Determine necessary systems modifications | August 15, 2000 |
| ♦ Determine and announce national roll-out strategy | August 30, 2000 |

**b. Restricting Loan Points and Fees.** FHA will impose a cap on the total amount of points and fees charged FHA borrowers

**Implementation Timeline:**

| | |
|---|---|
| ♦ Finalize proposed federal regulation (rule) term sheet | June 30, 2000 |
| ♦ Complete drafting of regulations | July 20, 2000 |
| ♦ Complete HUD clearance process/deliver to OMB | August 7, 2000 |
| ♦ Complete OMB review/deliver to Hill | August 30, 2000 |
| ♦ Complete Hill review | September 15, 2000 |
| ♦ Issue proposed rule in federal register | October 1, 2000 |
| ♦ Close 60 day comment period | December 1, 2000 |
| ♦ Issue final rule | December 31, 2000 |

**c. Tightening Use of Gifts for Downpayment.** FHA will issue new and clearer guidance designed to tighten controls on FHA gift letters and enhance monitoring of these provisions.

**Implementation Timeline:**

| | |
|---|---|
| ♦ Complete draft Mortgage Letter implementing reforms | June 23, 2000 |
| ♦ Issue final Mortgagee Letter | July 10, 2000 |

**d. Using "SWAT" Teams to Identify Unscrupulous Appraisers and Predatory Lenders in Hot Zones.** FHA identified a number of apparently fraudulent practices on the part of FHA appraisers and lenders who be referred to HUD's Enforcement Center, disciplinary action, and if appropriate, to HUD's Office of Inspector General for possible criminal investigation. HUD plans to immediately extend the SWAT team approach to assess potential fraudulent activities in other cities now experiencing high numbers of FHA defaults and foreclosure

**Implementation Timeline:**

| | |
|---|---|
| ♦ Designate new Hot Zones | July 17, 2000 |
| ♦ Launch Swat Teams in new Hot Zones | August 15, 2000 |

**e. Implementing Credit Watch for Appraisers.** FHA will create an Appraisal Watch System that will rate appraisers on the performance of the loans linked to their appraisals. Appraisers with a consistent pattern of participating in loans that quickly move to foreclosure will be targeted for further review and, if appropriate, removed from the FHA Appraisal Roster.

**Implementation Timeline:**

| | |
|---|---|
| ♦ Complete data analysis of appraiser performance | June 23, 2000 |
| ♦ Finalize selection criteria | June 30, 2000 |
| ♦ Finalize regulation term sheet | July 12, 2000 |
| ♦ Complete HUD clearance process/Deliver to OMB | August 1, 2000 |
| ♦ Complete OMB review/deliver to Hill | August 30, 2000 |
| ♦ Complete Hill review | September 15, 2000 |
| ♦ Publish proposed rule in Federal Register | October 1, 2000 |
| ♦ Complete 60 day comment period | December 1, 2000 |
| ♦ Issue Final Rule | December 31, 2000 |

**f. Suspending Abusive Real Estate Brokers.** FHA will immediately review the list of participating real estate brokers and terminate unscrupulous brokers from future participation in FHA programs.

**Implementation Timeline:** FHA already has authority and process to suspend abusive real estate brokers, termination actions will be ongoing.

**g. Transition to a More Limited FHA Moratorium on Foreclosures**: Now that FHA has instituted a flip check into the loan origination process, using the prior sales record database to identify property flips prior to the assignment of an FHA case number, the Department plans to scale back the moratorium to just a few heavily impacted neighborhoods. At the same time, in order to identify potential property flips of loans already insured by FHA, the Department will begin immediately to run a check of prior sales records for all loans that go into default. Those loans that show an indication of possible loan flipping will be investigated immediately. In this manner, FHA will prevent potential property flips from being insured going forward, and also will be able to identify any potential property flips at the point of a 90 day default.

Figure 1

# Subprime Share of Foreclosures and Originations in Low-Income Neighborhoods

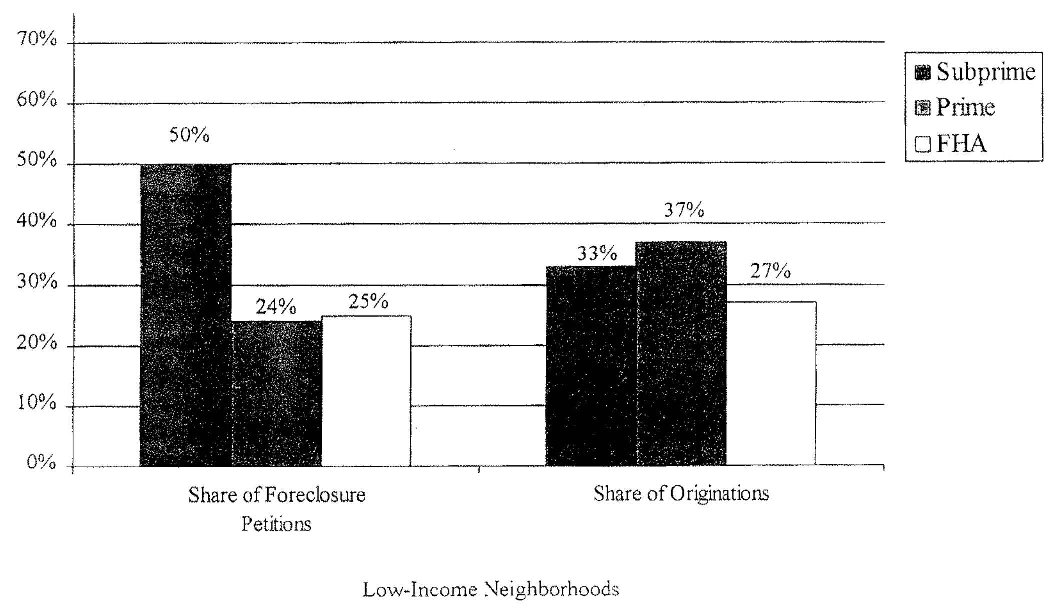


**Figure 2**

# Subprime Share of Foreclosures and Originations in Predominantly Black Neighborhoods

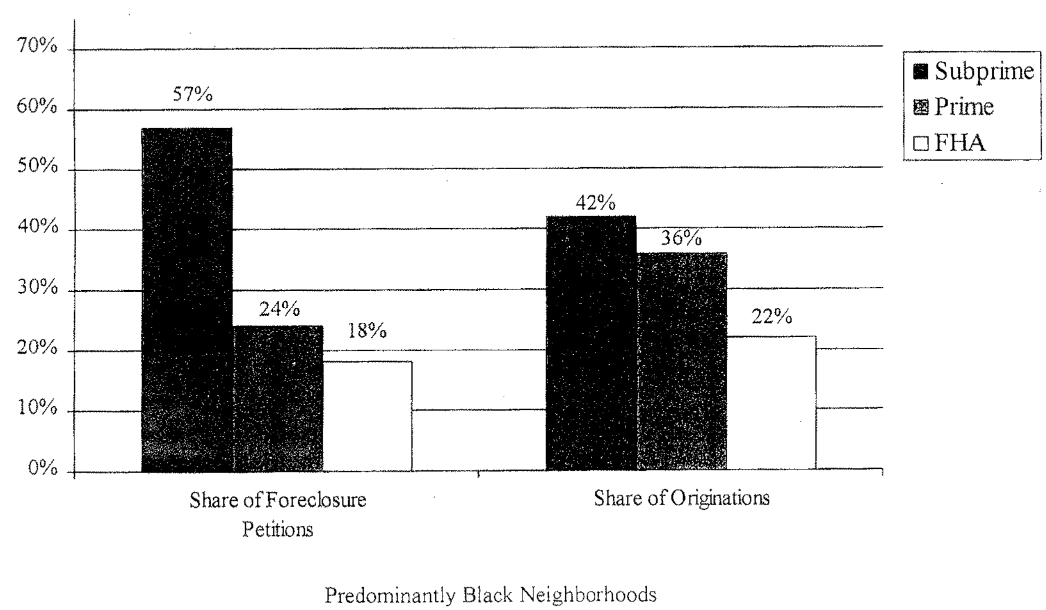
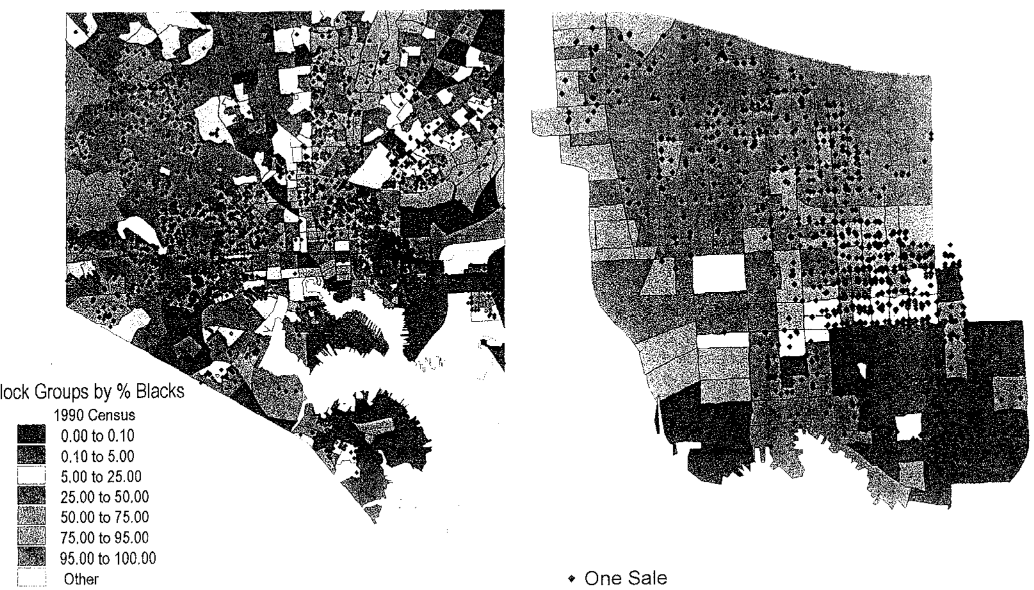


Figure 3

# 1990-1999 Property Sales in Baltimore Greater Than 100% Increased Value Less Than Four Months Turnover

Figure 4

# 1995-1999 Property Sales in Baltimore, Patterson Park Greater Than 50% Increased Value Less Than Six Months Turnover

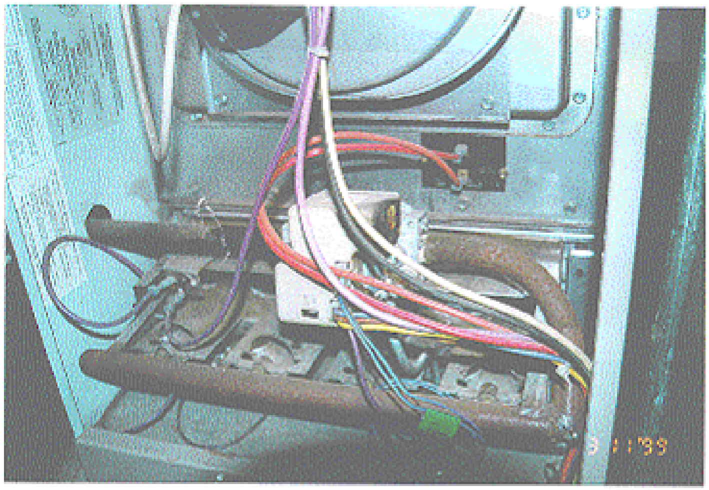


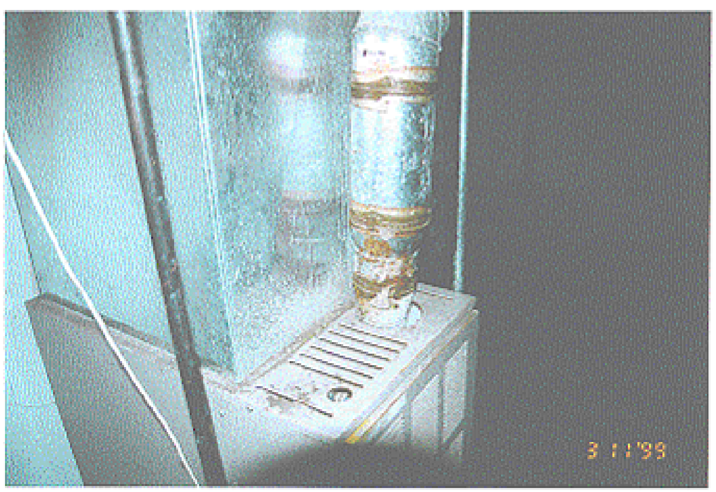

HUD/S/OSA/4-2000

Senate Permanent Subcommittee
On Investigations

EXHIBIT # 3a.

Burned gas regulator.



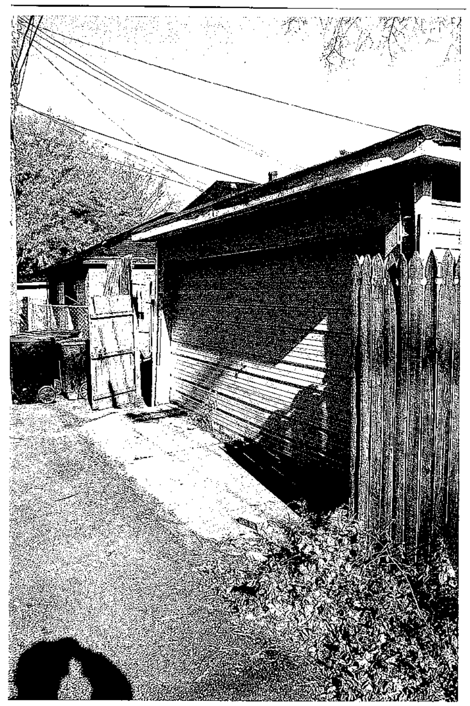




Dangerous flue connections.

Stairs are very narrow.

Three plus layers of roofing.

Deck nailed through the roof.



Garage door not working, garage is moving.

Kitchen floor is damaged.

Poor ceramic tile work.

Water leaks.

Loose siding.

Senate Permanent Subcommittee
On Investigations

EXHIBIT # 3b.

Illinois Association of REALTORS®
# RESIDENTIAL REAL PROPERTY DISCLOSURE REPORT

NOTICE: THE PURPOSE OF THIS REPORT IS TO PROVIDE PROSPECTIVE BUYERS WITH INFORMATION ABOUT MATERIAL DEFECTS IN THE RESIDENTIAL REAL PROPERTY. THIS REPORT DOES NOT LIMIT THE PARTIES RIGHT TO CONTRACT FOR THE SALE OF RESIDENTIAL REAL PROPERTY IN "AS IS" CONDITION. UNDER COMMON LAW SELLERS WHO DISCLOSE MATERIAL DEFECTS MAY BE UNDER A CONTINUING OBLIGATION TO ADVISE THE PROSPECTIVE BUYERS ABOUT THE CONDITION OF THE RESIDENTIAL REAL PROPERTY EVEN AFTER THE REPORT IS DELIVERED TO THE PROSPECTIVE BUYER. COMPLETION OF THIS REPORT BY SELLER CREATES LEGAL OBLIGATIONS ON SELLER THEREFORE SELLER MAY WISH TO CONSULT AN ATTORNEY PRIOR TO COMPLETION OF THIS REPORT.

Property Address: 130 N LATROBE
City, State & Zip Code: CHGO IL 60644
Seller's Name: RICHARD B. NELSON

This report is a disclosure of certain conditions of the residential real property listed above in compliance with the Residential Real Property Disclosure Act. This information is provided as of 7-21, 1995 and does not reflect any changes made or occurring after that date or information that becomes known to the seller after that date. The disclosures herein shall not be deemed warranties of any kind by the seller or any person representing any party in this transaction.

In this form, "am aware" means to have actual notice or actual knowledge without any specific investigation or inquiry. In this form a "material defect" means a condition that would have a substantial adverse effect on the value of the residential real property or that would significantly impair the health or safety of future occupants of the residential real property unless the seller reasonably believes that the condition has been corrected.

The seller discloses the following information with the knowledge that even though the statements herein are not deemed to be warranties, prospective buyers may choose to rely on this information in deciding whether or not and on what terms to purchase the residential real property.

The seller represents that to the best of his or her actual knowledge, the following statements have been accurately noted as "yes", (correct), "no" (incorrect) or "not applicable" to the property being sold. If the seller indicates that the response to any statement, except number 1, is yes or not applicable, the seller shall provide an explanation, in the additional information area of this form.

| | YES | NO | N/A | |
|---|---|---|---|---|
| 1. | | ✓ | | Seller has occupied the property within the last 12 months. (No explanation is needed.) |
| 2. | | ✓ | | I am aware of flooding or recurring leakage problems in the crawlspace or basement. |
| 3. | | ✓ | | I am aware that the property is located in a flood plain or that I currently have flood hazard insurance on the property. |
| 4. | | ✓ | | I am aware of material defects in the basement or foundation (including cracks and bulges). |
| 5. | | ✓ | | I am aware of leaks or material defects in the roof, ceilings or chimney. |
| 6. | | ✓ | | I am aware of material defects in the walls or floors. |
| 7. | | ✓ | | I am aware of material defects in the electrical system. |
| 8. | | ✓ | | I am aware of material defects in the the plumbing system (includes such things as water heater, sump pump, water treatment system, sprinkler system, and swimming pool). |
| 9. | | ✓ | | I am aware of material defects in the well or well equipment. |
| 10. | | ✓ | | I am aware of unsafe conditions in the drinking water. |
| 11. | | ✓ | | I am aware of material defects in the heating, air conditioning, or ventilating systems. |
| 12. | | ✓ | | I am aware of material defects in the fireplace or woodburning stove. |
| 13. | | ✓ | | I am aware of material defects in the septic, sanitary sewer, or other disposal system. |
| 14. | | ✓ | | I am aware of unsafe concentrations of radon on the premises. |
| 15. | | ✓ | | I am aware of unsafe concentrations of or unsafe conditions relating to asbestos on the premises. |
| 16. | | ✓ | | I am aware of unsafe concentrations of or unsafe conditions relating to lead paint, lead water pipes, lead plumbing pipes or lead in the soil on the premises. |
| 17. | | ✓ | | I am aware of mine subsidence, underground pits, settlement, sliding, upheaval, or other earth stability defects on the premises. |
| 18. | | ✓ | | I am aware of current infestations of termites or other wood boring insects. |
| 19. | | ✓ | | I am aware of a structural defect caused by previous infestations of termites or other wood boring insects. |
| 20. | | ✓ | | I am aware of underground fuel storage tanks on the property. |
| 21. | | ✓ | | I am aware of boundary or lot line disputes. |
| 22. | | ✓ | | I have received notice of violation of local, state or federal laws or regulations relating to this property, which violation has not been corrected. |

THIS IS TO CERTIFY THAT
THIS IS A TRUE AND EXACT
COPY OF THE ORIGINAL
Wayne Swanson

Note: These disclosures are not intended to cover the common elements of a condominium, but only the actual residential real property including limited common elements allocated to the exclusive use thereof that form an integral part of the condominium unit.

If any of the above are marked "not applicable" or "yes", please explain here or use additional pages, if necessary:

Check here if additional pages used: _____

Seller certifies that seller has prepared this statement and certifies that the information provided is based on the actual notice or actual knowledge of the seller without any specific investigation or inquiry on the part of the seller. The seller hereby authorizes any person representing any principal in this transaction to provide a copy of this report, and to disclose any information in the report, to any person in connection with any actual or anticipated sale of the property.

Seller: [signature] Date: 7-21-95
Seller: RICHARD NELSON IS RE BROKER Date: ______

PROSPECTIVE BUYER IS AWARE THAT THE PARTIES MAY CHOOSE TO NEGOTIATE AN AGREEMENT FOR THE SALE OF THE PROPERTY SUBJECT TO ANY OR ALL MATERIAL DEFECTS DISCLOSED IN THIS REPORT ("AS IS"). THIS DISCLOSURE IS NOT A SUBSTITUTE FOR ANY INSPECTIONS OR WARRANTIES THAT THE PROSPECTIVE BUYER OR SELLER MAY WISH TO OBTAIN OR NEGOTIATE. THE FACT THAT THE SELLER IS NOT AWARE OF A PARTICULAR CONDITION OR PROBLEM IS NO GUARANTEE THAT IT DOES NOT EXIST. PROSPECTIVE BUYER IS AWARE THAT HE MAY REQUEST AN INSPECTION OF THE PREMISES PERFORMED BY A QUALIFIED PROFESSIONAL.

Prospective Buyer: X Shirley A. Rollins Date: 7/21/[illegible] Time: 1:00 PM
Prospective Buyer: X [illegible signature] Date: 7/21/[illegible] Time: [illegible]

108 Revised 6/94

Senate Permanent Subcommittee
On Investigations

EXHIBIT # 3c.

LN: 0100636501 BORR: SHIRLEY A. ROLLINS STEKEENA A. ROLLINS CASE NO: 131:8031183-7

## MONTHLY INCOME AND COMBINED HOUSING EXPENSE INFORMATION

| Gross Monthly Income | Borrower | Co-Borrower | Total | Combined Monthly Housing Expense | Present | Proposed |
|---|---|---|---|---|---|---|
| Base Empl. Income* | $ | $ | $ | Rent | $ 555.00 | |
| Overtime | | | | First Mortgage (P&I) | | $ 751.53 |
| Bonuses | | | | Other Financing (P&I) | | |
| Commissions | | | | Hazard Insurance | | 35.00 |
| Dividends/Interest | | | | Real Estate Taxes | | 62.88 |
| Net Rental Income | 618 | | 618 | Mortgage Insurance | | 48.21 |
| Other (before completing, see the notice in "describe other income," below) | 1826 | 601 | 2427 | Homeowner Assn. Dues | | |
| | | | | Other: | | |
| Total | $ 2444 | $ 601 | $ 3045 | Total | $ 555.00 | $ 897.62 |

* Self Employed Borrower(s) may be required to provide additional documentation such as tax returns and financial statements.

| B/C | Describe Other Income Notice: Alimony, child support, or separate maintenance income need not be revealed if the Borrower (B) or Co-Borrower (C) does not choose to have it considered for repaying this loan. | Monthly Amount |
|---|---|---|
| B | SSI ($573) AND FOSTER CARE ($1253) | $ 1826 |
| C | FOSTER CARE | 601 |
| | | |

## VI. ASSETS AND LIABILITIES

This Statement and any applicable supporting schedules may be completed jointly by both married and unmarried Co-Borrowers if their assets and liabilities are sufficiently joined so that the Statement can be meaningfully and fairly presented on a combined basis; otherwise separate Statements and Schedules are required. If the Co-Borrower section was completed about a spouse, this Statement and supporting schedules must be completed about that spouse also.

Completed [ ] Jointly [XX] Not Jointly

| ASSETS Description | Cash or Market Value |
|---|---|
| Cash deposit toward purchase held by: EASY LIFE REALTY | $ 6500 |
| List checking and savings accounts below | |
| Name and address of Bank, S&L, or Credit Union: GLADSTONE-NORWOOD TRUST & SAVINGS 5200 NORTH CENTRAL AVENUE CHICAGO IL 60630 | |
| Acct. no. 2276111-80 | $ 300 |
| Name and address of Bank, S&L, or Credit Union | |
| Acct. no. | $ |
| Name and address of Bank, S&L, or Credit Union | |
| Acct. no. | $ |
| Name and address of Bank, S&L, or Credit Union | |
| Acct. no. | $ |
| Stocks & Bonds (Company name/number & description) | $ |
| Life insurance net cash value | $ |
| Face amount: $ | |
| Subtotal Liquid Assets | $ 6800 |
| Real estate owned (enter market value from schedule of real estate owned) | $ |
| Vested interest in retirement fund | $ |
| Net worth of business(es) owned (attach financial statement) | $ |
| Automobiles owned (make and year) PONTIAC 1980 | $ 5500 |
| Other Assets (itemize) PERS PROP | $ 30300 |
| Total Assets a. | $ 42300 |

Liabilities and Pledged Assets. List the creditor's name, address and account number for all outstanding debts, including automobile loans, revolving charge accounts, real estate loans, alimony, child support, stock pledges, etc. Use continuation sheet, if necessary. Indicate by (*) those liabilities which will be satisfied upon sale of real estate owned or upon refinancing of the subject property.

| LIABILITIES | Monthly Pmt. & Mos. Left to Pay | Unpaid Balance |
|---|---|---|
| Name and address of Company / Acct. no. | $ Pmt./Mos. / | $ |
| Name and address of Company / Acct. no. | $ Pmt./Mos. / | $ |
| Name and address of Company / Acct. no. | $ Pmt./Mos. / | $ |
| Name and address of Company / Acct. no. | $ Pmt./Mos. / | $ |
| Name and address of Company / Acct. no. | $ Pmt./Mos. / | $ |
| Name and address of Company / Acct. no. | $ Pmt./Mos. / | $ |
| Name and address of Company / Acct. no. | $ Pmt./Mos. / | $ |
| Alimony/Child Support/Separate Maintenance Payments Owed to: | $ | |
| Job Related Expense (child care, union dues, etc.) | $ | |
| Total Monthly Payments | $ | |
| Net Worth (a minus b) $ 42300 | Total Liabilities b. | $ |

| Borrower's Signature: | Date | Co-Borrower's Signature: | Date |
|---|---|---|---|
| X | | X | |

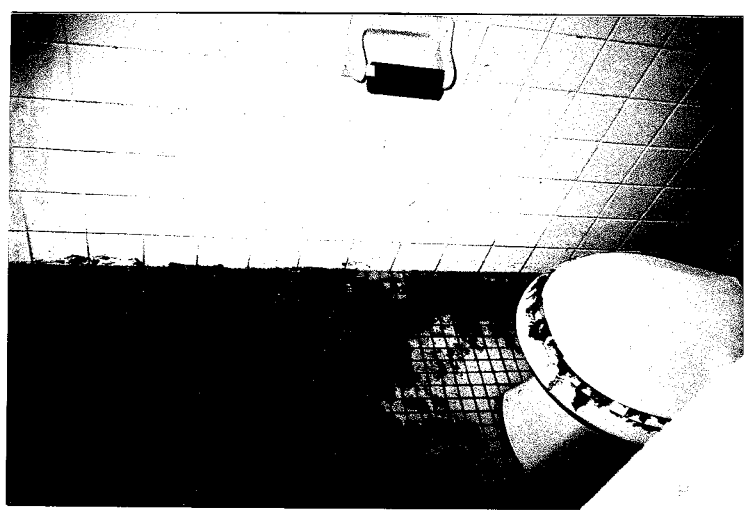
Freddie Mac Form 65 10/92 Fannie Mae Form 1003 10/92

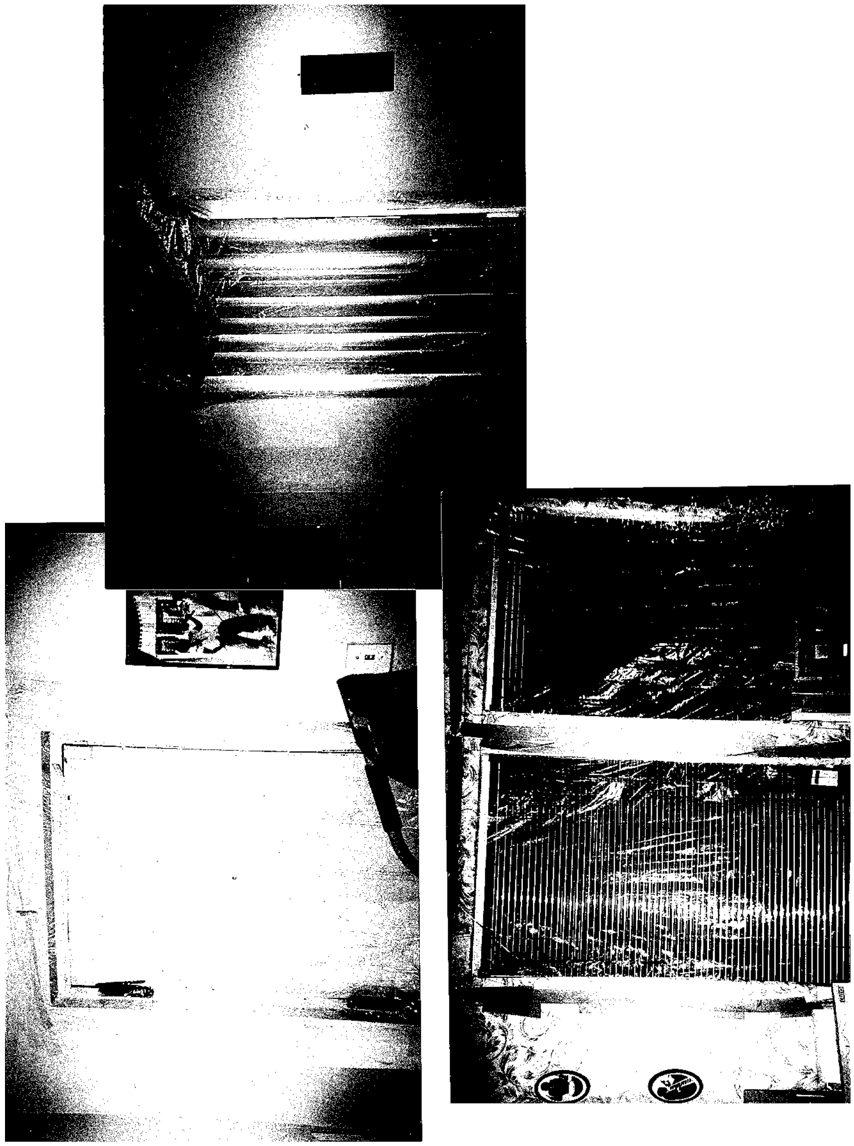
-21 (9210).02

Page 2 of 4

Senate Permanent Subcommittee
On Investigations

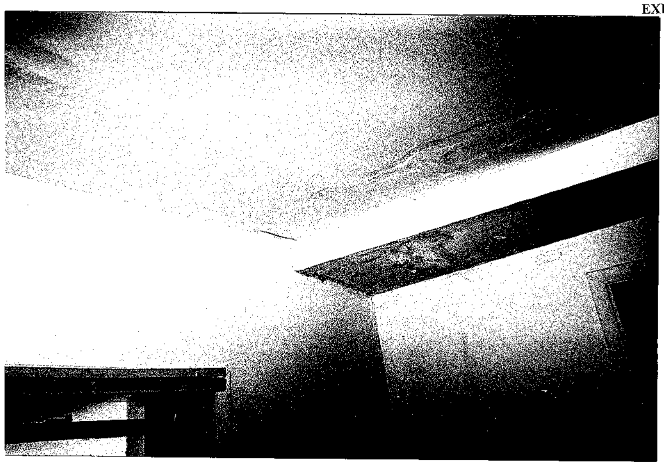
EXHIBIT # 4a.

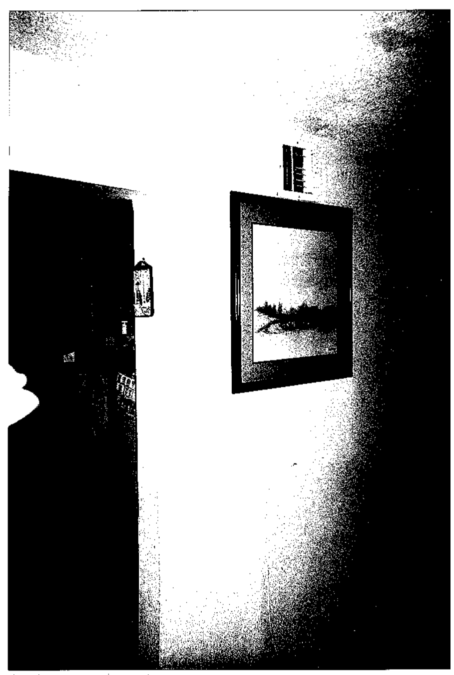


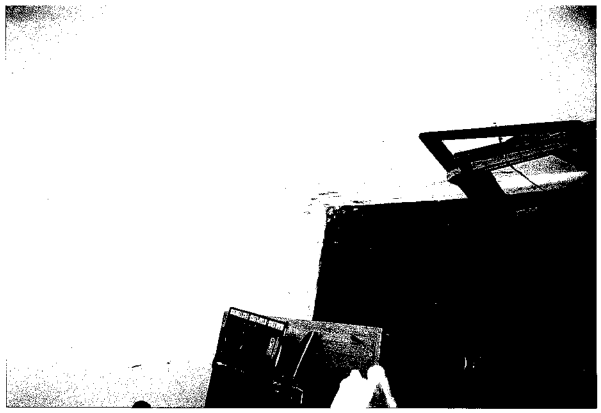


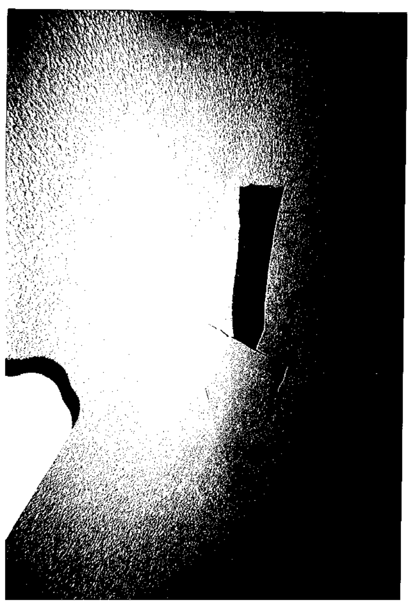
Senate Permanent Subcommittee
On Investigations

EXHIBIT # 5a.

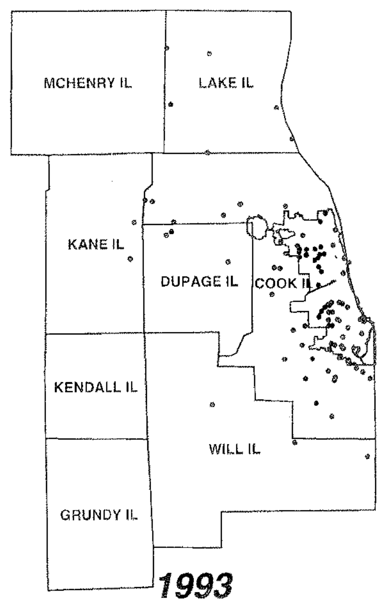








# Foreclosures Started by Subprime Lenders in Chicagoland

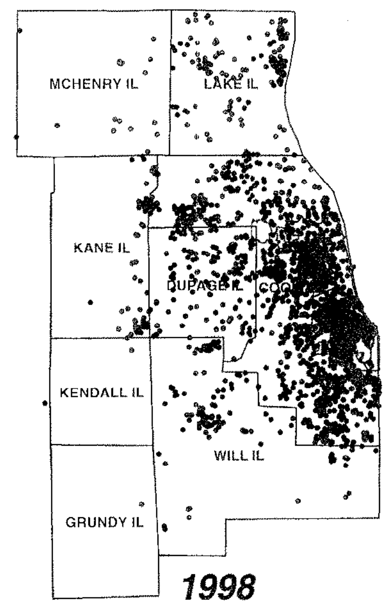



**1993**

**94 Foreclosures**

55 in Chicago

39 in the Suburbs




**1998**

**3,502 Foreclosures**

1,785 in Chicago

1,717 in the Suburbs

Senate Permanent Subcommittee
On Investigations

EXHIBIT # 6

Source: Foreclosure Report of Chicago
*Data excludes all known FHA and VA loans.

National Training and Information Center, 1999
810 N. Milwaukee Ave. Chicago, IL 60622 Phone: 312/243-3035

United States General Accounting Office

GAO

Report to Congressional Requesters

Senate Permanent Subcommittee
On Investigations

EXHIBIT # 7

April 2000

# SINGLE-FAMILY HOUSING

# Stronger Oversight of FHA Lenders Could Reduce HUD's Insurance Risk

G A O
Accountability * Integrity * Reliability

GAO/RCED-00-112

# Contents



**Abbreviations**

| | |
|---|---|
| CHUMS | Computerized Homes Underwriting Management System |
| FHA | Federal Housing Administration |
| GAO | General Accounting Office |
| HUD | Department of Housing and Urban Development |

GAO
Accountability * Integrity * Reliability

United States General Accounting Office
Washington, D.C. 20548

Resources, Community, and
Economic Development Division

B-283389

April 28, 2000

The Honorable Rick A. Lazio
Chairman, Subcommittee on Housing
and Community Opportunity
Committee on Banking
and Financial Services
House of Representatives

The Honorable Susan M. Collins
Chairman, Permanent Subcommittee
on Investigations
Committee on Governmental Affairs
United States Senate

Every year, the Department of Housing and Urban Development (HUD), through its Federal Housing Administration (FHA), insures billions of dollars in home mortgage loans made by private lenders. During fiscal year 1999 alone, FHA insured 1.3 million mortgages valued at about $124 billion. While FHA insures lenders against nearly all losses resulting from foreclosed loans, it relies on the lenders to underwrite the loans and determine their eligibility for FHA mortgage insurance. Recent cases of mortgage fraud across the country have raised concerns about HUD's oversight of these lenders. For example, in December 1999, HUD's Office of the Inspector General and the Department of Justice announced criminal charges against 39 California mortgage lenders, real estate professionals, and other persons accused of obtaining more than $110 million in fraudulent FHA-insured loans.

As you requested, this report provides information on HUD's oversight of lenders participating in FHA's mortgage insurance programs for single-family homes. While almost 10,000 lending institutions are approved to participate in FHA's single-family mortgage insurance programs, only about 2,900 of these institutions also have direct endorsement authority, meaning that they can underwrite loans and determine their eligibility for FHA mortgage insurance without HUD's prior review. Specifically, this report addresses the following questions: (1) How well does HUD ensure that lenders granted direct endorsement authority by FHA are qualified to receive such authority? (2) To what extent does HUD focus on high-risk lenders in monitoring the lenders participating in FHA's mortgage insurance programs? (3) To what extent is HUD holding lenders accountable for poor performance? To address these questions, we reviewed the activities of HUD's headquarters and its four homeownership centers in Atlanta, Georgia; Denver, Colorado; Philadelphia, Pennsylvania; and Santa Ana, California, which administer HUD's single-family housing activities in all 50 states, the District of Columbia, and Puerto Rico. Our review focused on the adequacy of HUD's policies and procedures for overseeing lenders. We performed limited tests and analyses to determine whether these policies and procedures were properly utilized to limit HUD's insurance risk.

## Results in Brief

HUD's process for granting FHA-approved lenders direct endorsement authority—the ability to underwrite loans and determine their eligibility for FHA mortgage insurance without HUD's prior review—provides limited assurance that lenders receiving this authority are qualified. According to HUD's guidance, FHA-approved lenders seeking direct endorsement authority must demonstrate "acceptable performance" in underwriting at least 15 mortgage loans, which undergo evaluations, known as *preclosing reviews*, by HUD's homeownership centers. However, the guidance does not define what would constitute overall acceptable performance on the 15 loans. In the absence of such a clear definition, HUD's homeownership centers' recent performance in approving lenders for direct endorsement authority was uneven. In the 6 months prior to our 1999 visits, the centers granted direct endorsement authority to a total of 36 lenders. While many of these lenders had demonstrated proficiency in underwriting mortgages, many others made multiple and serious underwriting errors. Overall, 12 of the 36 lenders had received 4 or more "poor" ratings from the centers for their last 15 preclosing reviews.

Contrary to HUD's guidance, the homeownership centers' monitoring of lenders does not adequately focus on the lenders and loans that pose the greatest insurance risks to the Department. On-site evaluations of lenders' operations—known as *lender reviews*—are one of HUD's primary tools for assessing the quality of lenders' mortgage-lending practices. HUD's guidance states that 85 percent of the lender reviews should be targeted at high-risk lenders. However, the homeownership centers have often not reviewed the lenders that they consider to be the highest risk. For example, although the Philadelphia center conducted reviews of 228 lenders during fiscal year 1999, it reviewed only 39 of the 131 high-risk lenders (about 30 percent) that it designated as high priority for review that year. HUD officials told us that the lack of experienced staff and limited travel funds impeded their ability to visit and review the riskiest lenders. Desk audits to evaluate the underwriting quality of individual loans insured by FHA—known as *technical reviews*—are another important tool for overseeing lenders. Although the homeownership centers met the Department's goal to perform technical reviews of no less than 10 percent of all loans insured in fiscal year 1999, they generally did not target these reviews at high-risk lenders and loans as recommended by HUD's guidance.

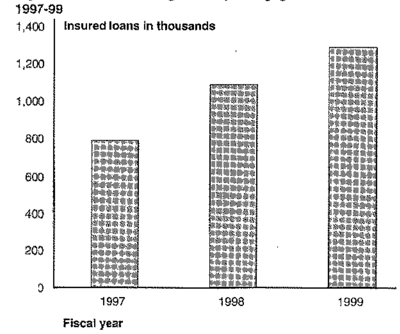
HUD has not taken sufficient steps to hold lenders accountable for poor performance and program violations. Although HUD's guidance allows the homeownership centers to suspend the direct endorsement authority of lenders that fail to comply with FHA's underwriting requirements, the centers have made limited use of this ability. In fiscal year 1999 the Philadelphia center suspended the direct endorsement authority of eight lenders; however, the other three centers did not take this action against any lenders. Furthermore, HUD's technical review ratings for fiscal year 1999 showed frequent noncompliance by lenders with FHA's requirements, indicating that many other lenders may be candidates for this action. For example, we identified 206 lenders that received "poor" ratings for their mortgage credit decisions in more than 30 percent of the loans that HUD reviewed in fiscal year 1999. Furthermore, on the basis of our analysis, if HUD had reviewed all of the lenders' fiscal year 1999 loans, the percentage of poor ratings could have been expected to exceed 30 percent. Of these lenders, 131 made 10 or more FHA-insured loans in fiscal year 1999. As of October 1, 1999, HUD's homeownership centers had not suspended the direct endorsement authority of any of the 131 lenders we identified. In May 1999, HUD's headquarters implemented its Credit Watch program to terminate the loan origination authority of lenders with excessive defaults and insurance claims on FHA-insured mortgages. However, because the program's regulations pertain only to the lenders that originated the troubled loans, HUD does not always hold accountable lenders that underwrote and approved the loans. According to HUD, the program's regulations did not permit the Department to take enforcement actions against these lenders.

This report makes recommendations designed to improve HUD's processes for (1) approving lenders to underwrite FHA-insured mortgages, (2) targeting lenders and loans for quality control reviews, and (3) taking enforcement actions against poorly performing lenders.

## Background

Established by the National Housing Act, FHA insures lenders against losses on mortgages for single-family homes. Lenders usually require mortgage insurance when a homebuyer has a down payment of less than 20 percent of the value of the home. FHA mortgage insurance allows a homebuyer to make a modest down payment and obtain a mortgage for the balance of the purchase price. FHA plays a particularly large role in certain market segments, including low-income borrowers and first-time homebuyers. During fiscal years 1997 through 1999, the number of single-family mortgage loans that FHA insured grew from approximately 800,000 to nearly 1.3 million—a 63-percent increase. (See fig. 1.) For the 3 years combined, FHA insured over 3 million mortgages with a total value of $292 billion.

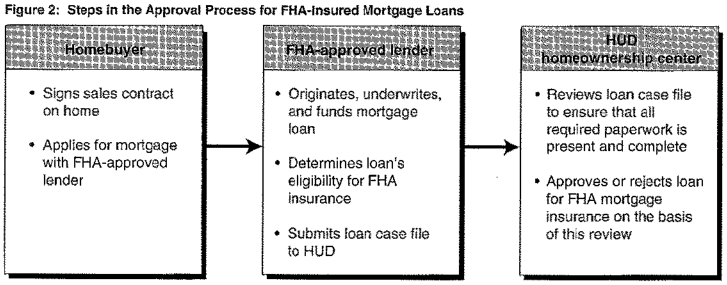
**Figure 1: Number of Single-Family Mortgage Loans Insured by FHA, Fiscal Years 1997-99**




Source: HUD.

A homebuyer seeking a FHA-insured mortgage must submit a mortgage application to a FHA-approved lender. Once the lender approves the loan, it sends the loan documents to HUD for approval of FHA mortgage insurance. (See fig. 2.) If the borrower defaults and the lender subsequently forecloses on the loan, the lender can file an insurance claim with HUD for the unpaid balance of the loan. FHA insures most of its mortgages for single-family housing under its Mutual Mortgage Insurance Fund (Fund). To cover lenders' losses, FHA collects insurance premiums that borrowers pay to lenders and deposits the premiums in the Fund. The Fund has historically been self-sufficient. An actuarial study by Deloitte & Touche LLP indicated that, as of September 30, 1999, the Fund exceeded the legislative target for capital reserves.

Figure 2: Steps in the Approval Process for FHA-Insured Mortgage Loans




Lenders must obtain approval from HUD to participate in FHA's mortgage programs. In addition to an application form and fee, lenders are required to submit supporting documentation, including the resumes of senior corporate officers; certified financial statements; and photographs and floor plans of the lender's main office. HUD uses this information to determine whether the applicants meet FHA's requirements for lending experience; financial worth; and adequacy of facilities, among other things. HUD also determines whether any of the lenders' principal officers are ineligible to participate in FHA's programs because of outstanding federal debts; because of recent bankruptcies or derogatory credit; or because they have been suspended, debarred, or otherwise excluded from the Department's programs and activities. Lenders must be annually recertified by HUD to maintain their FHA-approved status.

As of December 1999, about 9,950 lending institutions were approved to participate in FHA's mortgage insurance programs for single-family homes.

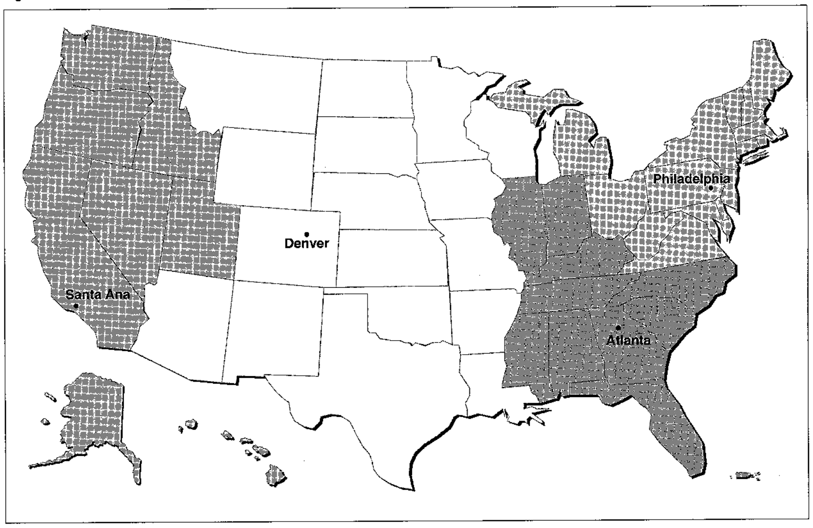
Most FHA-approved lenders are authorized to originate FHA-insured loans, meaning that they can accept mortgage applications, obtain employment verifications and credit histories on applicants, order appraisals, and perform other tasks that precede the loan underwriting process. Approximately 2,900 of the FHA-approved lending institutions also have direct endorsement authority, meaning that they can underwrite loans and determine their eligibility for FHA mortgage insurance without HUD's prior review.[1] Underwriting refers to a risk analysis that uses information collected during the origination process to decide whether to approve a loan. Virtually all FHA-insured mortgages for single-family homes are underwritten by lenders with direct endorsement authority. In 1996, as part of an effort to streamline its lender approval process, HUD stopped individually approving underwriters working for FHA lenders that were granted direct endorsement authority. Prior to 1996, underwriters seeking FHA's approval had to submit applications to HUD, and HUD reviewed and verified their experience and qualifications. HUD now relies on lenders to certify that their underwriters meet FHA's standards.

Some FHA-approved lenders with direct endorsement authority, known as *sponsoring lenders*, enter agreements to underwrite and fund loans originated by FHA lenders without direct endorsement authority, known as *loan correspondents*. About 40 percent of FHA's approved lenders are loan correspondents, meaning that they originate FHA-insured mortgages and sell or transfer the loan paperwork to sponsoring lenders for underwriting and approval. According to HUD's regulations, sponsoring lenders are responsible for the loan origination activities of their loan correspondents.

HUD's 2020 Management Reform Plan, which was announced in 1997, consolidated the single-family mortgage housing activities of HUD's 81 field offices into four homeownership centers, each of which is responsible for a multistate area. (See fig. 3.) Under the 2020 plan, HUD's single-family housing staff was cut by more than 50 percent. The homeownership centers are located in Atlanta, Georgia; Denver, Colorado; Philadelphia, Pennsylvania; and Santa Ana, California, and report directly to HUD's Deputy Assistant Secretary for Single-Family Housing.

[1]To be eligible to receive direct endorsement authority and to underwrite FHA-insured loans, a lender, in addition to meeting other HUD requirements, must be one of the following: (1) a member of the Federal Reserve System or an institution whose accounts are insured by the Federal Deposit Insurance Corporation or the National Credit Union Administration; (2) a financial institution whose principal activity is lending or the investing of funds in real estate mortgages; or (3) a federal, state, or municipal government agency.

Figure 3: Locations and Geographical Jurisdictions of HUD's Four Homeownership Centers




The centers are responsible for processing and approving mortgage insurance as well as several critical aspects of HUD's lender approval, monitoring, and enforcement activities. These responsibilities include (1) granting direct endorsement authority to qualified FHA-approved lenders; (2) on-site evaluations of lenders' operations, known as *lender reviews*, and monitoring lenders' performance through reviews of individual loans, known as *technical reviews*, and (3) taking and initiating enforcement actions against lenders that have not complied with FHA's requirements.

HUD's headquarters also has important approval, monitoring, and enforcement functions. For example, HUD's headquarters approves and annually recertifies lenders wishing to participate in FHA's mortgage programs. HUD's Credit Watch program, an initiative to identify and impose sanctions against lenders with unacceptably high rates of defaults and insurance claims on FHA-insured mortgages, is managed by HUD's Office of Lender Activities and Program Compliance. HUD's Mortgagee Review Board, an enforcement body chaired by HUD's Assistant Secretary for Housing-Federal Housing Commissioner,[2] can impose administrative sanctions against lenders, including withdrawing the lenders' authority to make FHA-insured loans.

## Direct Endorsement Approval Process Provides Limited Assurance That Lenders Are Qualified

HUD's process for granting FHA-approved lenders direct endorsement authority—the ability to underwrite loans and determine their eligibility for FHA mortgage insurance without HUD's prior review—provides only limited assurance that lenders receiving this authority are qualified. HUD's guidance does not adequately define the level of proficiency that lenders must achieve in order to receive direct endorsement authority. As a result, HUD's homeownership centers have applied the guidance differently and granted direct endorsement authority to lenders that demonstrated various levels of proficiency. Many lenders were approved by the centers despite making multiple underwriting errors. Lenders such as these may pose a high insurance risk to the Department once they begin underwriting and approving FHA-insured loans without HUD's prior review.

[2]The other members of the Board are HUD's General Counsel, Chief Financial Officer, Assistant Secretary for Administration, Assistant Secretary for Fair Housing and Equal Opportunity, and the President of the Government National Mortgage Association.

## Standards for Granting Direct Endorsement Authority Are Not Adequately Defined

HUD's homeownership centers are responsible for granting direct endorsement authority—the ability to underwrite loans and determine their eligibility for FHA mortgage insurance without HUD's prior review—to lenders participating in FHA's programs. According to HUD's guidance, FHA-approved lenders seeking direct endorsement authority must go through a probationary period during which they are required to demonstrate acceptable performance in underwriting at least 15 mortgage loans. At HUD's discretion, the probationary period may extend beyond 15 loans. The mortgages are submitted to and evaluated by HUD's homeownership centers against FHA's underwriting requirements before the lenders close the loans. Known as *preclosing reviews*, these evaluations rate various aspects of the lender's work, including the analysis of the mortgage credit decision and the property appraisal, as "good," "fair," or "poor."[3] A "good" rating indicates no underwriting deficiencies, a "fair" rating indicates the presence of deficiencies that did not significantly affect HUD's insurance risk, and a "poor" rating indicates that underwriting errors significantly increased HUD's insurance risk. HUD's guidance provides specific criteria for the centers to use in determining these ratings.

While HUD's guidance requires that lenders seeking direct endorsement authority demonstrate acceptable performance on their preclosing reviews, the guidance for what constitutes overall acceptable performance is unclear. For example, the guidance does not state whether acceptable performance requires that lenders receive all "good" scores or whether combinations of "good" and "fair" scores are permitted. The guidance makes no mention of whether a lender can receive any "poor" scores and still qualify for direct endorsement authority. As a result of HUD's vague performance standards, the four homeownership centers have interpreted what constitutes overall acceptable performance on the preclosing reviews differently. Philadelphia center officials said they generally approved only those lenders that had submitted at least 15 cases and had received only "good" or "fair" ratings in their last five preclosing reviews. The Denver and Atlanta centers interpreted the guidance as meaning that lenders had to submit a total of 15 loans for which they received only "good" or "fair" ratings in their preclosing reviews. Santa Ana center officials said they did not have strict requirements regarding the number of loans that had to receive "good" or "fair" ratings. While some officials at the centers believed

[3]A preclosing review rates the quality of the loan-closing documents, the property appraisal, the construction exhibits (for new or rehabilitated homes), and the mortgage credit evaluation of the borrower.

that the existing approval guidance gave them the flexibility they needed to make approval decisions, others believed that more specific guidance was necessary to ensure that the decisions were more consistent.

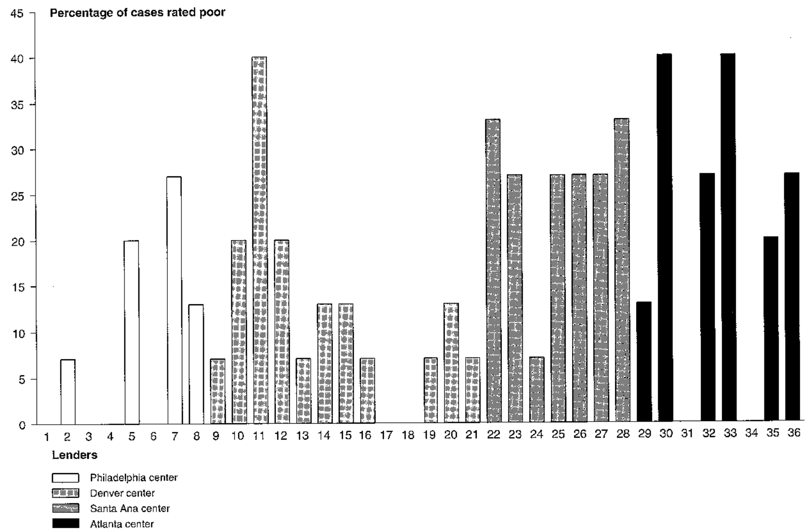
## Recently Approved Lenders Varied in Their Performance in Preclosing Reviews

HUD's four homeownership centers granted direct endorsement authority to a total of 36 lenders during the 6 months prior to our 1999 visits to the centers.[4] Approximately 230 other lenders were in the process of seeking but had not yet received direct endorsement authority at the time of our visits. The 36 lenders submitted an average of 18 loans to the centers for preclosing reviews.

We analyzed the 36 lenders' ratings in preclosing reviews to illustrate the different types of performance that the centers considered as acceptable. Specifically, we reviewed the ratings that each lender received for mortgage credit analysis—the evaluation of the borrower's credit worthiness—on the last 15 preclosing reviews before the lender received direct endorsement authority. Our analysis showed significant variations in what HUD's homeownership centers considered as acceptable performance, reflecting the vagueness and inconsistent application of HUD's approval standards. Overall, of the 36 lenders, 8 received no "poor" ratings during their last 15 preclosing reviews, while 3 received 6 "poor" ratings during their last 15 preclosing reviews. (See fig. 4.) The lenders' errors included their failure to (1) verify the borrower's employment and income, (2) ensure that the borrower had sufficient income to support the monthly mortgage payments, (3) explain delinquent accounts and collections on the borrower's credit reports, and (4) properly calculate the borrower's debts or liabilities. Twelve of the 36 lenders received "poor" ratings in 4 or more of their last 15 preclosing reviews. In other words, these 12 lenders made serious errors in underwriting over a quarter of the mortgages they submitted to HUD to demonstrate their abilities to comply with HUD's requirements. While the centers felt that the lenders they approved had shown the ability to underwrite FHA-insured loans properly, we believe that lenders such as these 12 may pose a high insurance risk to the Department once they begin underwriting and approving loans without HUD's prior review.

[4] We visited the Philadelphia center in August 1999 and the Atlanta, Denver, and Santa Ana centers in October 1999.

**Figure 4: Frequency of Poor Ratings for Mortgage Credit Analysis Given to 36 Approved Lenders in Their Last 15 Preclosing Reviews**




Note: Our analysis included all 36 lenders to whom the four homeownership centers had granted direct endorsement authority in the 6 months prior to our visits to the centers. We visited the Philadelphia center in August 1999 and the Denver, Santa Ana, and Atlanta centers in October 1999.

Source: GAO's analysis of data from HUD's homeownership centers.

## Monitoring Process Does Not Adequately Focus on Riskiest Lenders and Loans

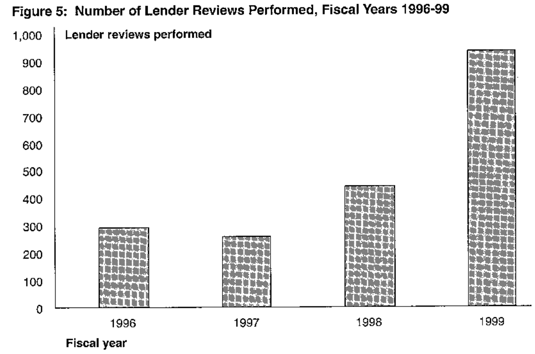
HUD's guidance stresses the importance of using risk analysis to allocate a larger share of monitoring resources to program activities that pose the highest risks to the Department. However, HUD's homeownership centers have not adequately focused their monitoring efforts on lenders and loans that pose the greatest insurance risks. The centers use two monitoring tools to ensure lenders' compliance with FHA's mortgage requirements: (1) on-site evaluations of lenders' operations, known as *lender reviews*, and (2) desk audits of the underwriting quality of individual loans already insured by FHA, known as *technical reviews*. In recent years, HUD substantially increased the number of lender reviews that it performs. However, contrary to HUD's guidance, the centers have not always reviewed the lenders they consider to be high risk. With respect to technical reviews, in fiscal year 1999, the centers met HUD's goals regarding the percentage of loans undergoing these reviews but, contrary to HUD's guidance, selected most of the loans at random instead of using a risk-based selection process. In addition, while contractors perform most of the homeownership centers' technical reviews, three of the four centers did not track the quality of the contractors' work against performance standards in the contracts.

### Lender Reviews Increased but Were Often Not of Riskiest Lenders

In recent years, HUD has placed greater emphasis on performing on-site evaluations of lenders' operations. These lender reviews typically involve an in-depth analysis of a sample of loans and assessments of lenders' internal control systems for making loans. If a lender review finds serious deficiencies with specific loans or the lender's internal controls, HUD may take actions that reduce the Department's insurance risk, such as requiring the lender to compensate HUD for financial losses that HUD incurred or may incur on certain loans. Staff assigned to each homeownership center's quality assurance division are responsible for scheduling and performing these reviews. During fiscal years 1996 through 1999, HUD increased the number of staff performing lender reviews from 23 to approximately 140. Over this period, the number of lender reviews that HUD conducted also increased. In fiscal year 1999, HUD's homeownership centers conducted 932 lender reviews, exceeding the Department's goal of 900 reviews.[5] (See fig. 5.)

[5]HUD's fiscal year 1999 goals required each of the four homeownership centers to conduct 225 lender reviews. All four centers exceeded this goal.

Figure 5: Number of Lender Reviews Performed, Fiscal Years 1996-99




Source: GAO's analysis of data from HUD.

HUD's guidance states that lenders should be rated and prioritized for review and that 85 percent of the reviews should be targeted at high-risk lenders, while 15 percent should be selected randomly. Focusing on high-risk lenders increases the likelihood that HUD will uncover improper lending practices, which the Department can then take steps to curtail. However, we found that the homeownership centers did not always review the lenders that they considered to pose the highest risks. The Philadelphia center was the only one that had developed and could provide us with a list of high-risk lenders that it considered to be a high priority for review in fiscal year 1999.[6] The list consisted of 131 lenders in the center's geographical jurisdiction. However, despite conducting reviews of 228 lenders during fiscal year 1999, the center reviewed just 39 of the 131 lenders on its priority list. Had the Philadelphia center complied with

[6]The Denver center's quality assurance division produces prioritized targeting lists for each of the HUD field office locations within the center's geographic jurisdiction. However, the division did not save copies of the lists it used for targeting lenders in fiscal years 1998 or 1999. Therefore, we were unable to determine the extent to which the highest-priority lenders had been reviewed.

HUD's guidance and targeted 85 percent of its reviews at high-risk lenders, the center would have been able to review all of the lenders on its priority list. We were unable to determine the extent to which the other three centers reviewed the lenders they considered to be the highest risk because they could not provide us with similar priority lists of high-risk lenders for their fiscal year 1999 reviews. However, officials at these centers told us that they often targeted for review those lenders that did not pose a high insurance risk to HUD. For instance, the director of the Santa Ana center's quality assurance division estimated that half of the reviews that the center performed in fiscal year 1999 were of lenders that had few or no early defaults. Because early defaults are an indicator of poor lending practices that may result in insurance losses, HUD considers them to be an important factor in assessing lenders' risk.

Homeownership center officials cited inexperienced staff and limited or uncertain travel funds as reasons why high-risk lenders were not always reviewed. According to center officials, most of the centers' 140 staff who conduct lender reviews assumed their current positions in fiscal years 1998 and 1999, largely from the pool of HUD field staff who remained unassigned after HUD's 1998 reorganization. The officials said that many of these individuals had no background in lender monitoring or mortgage credit issues. To address this problem, the officials said that they provided both classroom and on-the-job training to the new staff. However, center officials also told us that they generally did not allow staff with less than a year of experience to review high-risk lenders because their inexperience might lead them to overlook serious deficiencies. Furthermore, the centers' quality assurance directors told us that they typically had little or no travel funding during the first 2 to 3 months of the fiscal year. They said that during these periods, center staff are forced to identify and review lenders within commuting distances of the staffs' homes or offices—without primary regard to the lenders' risk—in order to avoid incurring travel expenses.

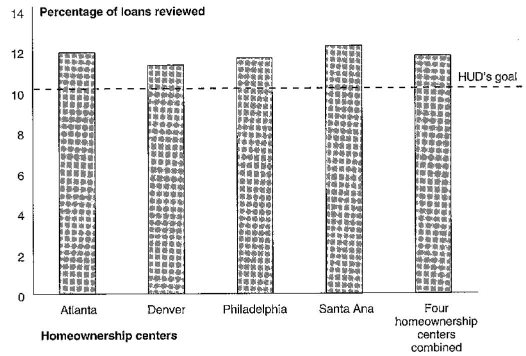
Furthermore, although HUD's guidance states that lenders should be rated and prioritized for review, the Department has not developed a systematic process for doing so. HUD's guidance lists several risk factors that should be considered in targeting lenders for reviews, including default rates, the late payment of mortgage insurance premiums to HUD, and the volume of business. But the guidance indicates neither how these factors should be weighted nor how lenders should be prioritized. As a result, the centers have not targeted lenders for reviews in a consistent manner. We found that neither the Santa Ana nor the Atlanta centers had standardized ways to assess lenders' risk and prioritize them for review. In contrast, the Philadelphia and Denver centers had implemented more systematic but different approaches. For example, the Philadelphia center established, as a high priority for review, those lenders that, during the previous 5 years, had made over 500 FHA-insured mortgages and had high percentages of loans that defaulted within 24 months relative to the national and corresponding state averages. By comparison, the Denver center focused on lenders that, during the previous 3 years, had the largest number of loans that defaulted within 13 months.

## Selection of Loans for Technical Reviews Was Not Based on Risk

Technical reviews—desk audits that evaluate the underwriting quality of individual loans already insured by FHA—are another tool that HUD uses to monitor the performance of lenders. Technical reviews that reveal serious deficiencies may result, among other things, in HUD's requiring the lenders to compensate the Department for financial losses or HUD's suspending the lenders' direct endorsement authority. While the homeownership centers met the numerical goals for conducting technical reviews during fiscal year 1999, the reviews, contrary to HUD's guidance, did not focus on loans that (1) exhibit high-risk characteristics or (2) were made by lenders with known performance problems or newly approved lenders. As a result, underwriting practices that significantly increase HUD's insurance risk may be going undetected.

All four of HUD's homeownership centers met the Department's goal to perform technical reviews on no less than 10 percent of the FHA-insured mortgage loans made during fiscal year 1999. The four centers combined performed 151,575 technical reviews in fiscal year 1999, representing 11.7 percent of the loans that FHA insured that year. (See fig. 6.)

**Figure 6: Percentage of Loans Receiving Technical Reviews by Homeownership Center, Fiscal Year 1999**




Source: GAO's analysis of data from HUD.

The homeownership centers, however, have not effectively implemented HUD's guidance, which recommends that high-risk loans should be selected for technical reviews. The guidance cites as high-risk loans those mortgage transactions involving multiunit dwellings; foreclosed HUD-owned properties; and borrowers with unusually high expenses relative to their income, among other factors. According to HUD officials, loans that exhibit these high-risk characteristics are, all other things being equal, more likely to be subject to default and/or contain underwriting errors than loans that do not. Instead, the centers rely primarily on a random process for selecting loans for technical reviews. According to center officials, HUD's Computerized Homes Underwriting Management System (CHUMS)—a computer system that assists and supports HUD staff in processing mortgage insurance for single-family homes—is programmed to randomly select a certain percentage of each lender's loans. However, CHUMS currently cannot automatically identify and select for review those loans that exhibit high-risk characteristics. Center officials told us that they sometimes manually selected high-risk loans for review but that the large volume of loans they processed for FHA insurance, coupled with staffing constraints, made it impractical to do this on a routine basis. According to HUD officials, the Department is developing a "mortgage scorecard" system, which, they believe, will enable HUD to readily identify high-risk loans for technical reviews by assigning risk scores to all FHA-insured mortgage loans on the basis of various characteristics of the loans. The officials said that they hope to fully implement this system by the end of fiscal year 2001.

CHUMS permits homeownership center staff to adjust the percentage of each lender's loans that are selected for technical reviews. HUD's guidance suggests that 5 to 10 percent of a lender's loans should be selected for technical reviews but that this percentage should be increased up to 100 percent if problems are noted with the lender's performance (e.g., high default rates, poor technical review ratings, or homebuyers' complaints). However, the centers have infrequently used their ability to adjust the percentage of lenders' loans selected for technical reviews to more closely monitor lenders whose performance problems may increase HUD's insurance risk. HUD's guidance states also that the centers should perform technical reviews of 100 percent of the FHA-insured loans that are made by lenders that are newly granted direct endorsement authority for 6 months or through their first 50 loans. However, we found that the centers did not consistently follow this guidance and lacked information systems to readily identify and track the technical review ratings of new direct endorsement lenders. For example, officials at the Philadelphia center told us they were not aware of the guidance and selected only 10 percent of these lenders' loans for technical reviews.

In contrast to HUD, both Fannie Mae and Freddie Mac—government-sponsored enterprises that purchase home mortgages and issue mortgage-backed securities—perform quality control reviews on samples of loans selected on the basis of risk as well as samples of loans selected at random. Officials with both organizations told us they had databases and statistical models to generate these samples automatically. The officials said they used risk-based samples to focus their monitoring resources at high-risk loans and lenders that made such loans.[7] They said they used random

[7]Some of the risk factors used by Fannie Mae and Freddie Mac to identify high-risk loans may be applicable to FHA's loan portfolio, while other factors may not. Fannie Mae and Freddie Mac consider the specific factors they use to assess risk as confidential business information.

samples to determine the prevalence of underwriting deficiencies throughout their entire loan portfolios.

## Homeownership Centers' Oversight of Technical Review Contractors Was Limited

The large majority of HUD's technical reviews are performed by firms under contract with the homeownership centers.[8] Each contract contains specific performance standards expressed as the maximum acceptable percentage of reviews that could contain significant errors or omissions. However, we found that three of the four centers were not tracking the contractors' work against these standards. As a result, these centers lack the information necessary to evaluate the quality of the contractors' work or to determine whether actions should be taken against the contractors for poor performance.

Each technical review contract states that each month, HUD staff will review the accuracy and completeness of the contractor's work and provide the contractors with performance feedback. The contracts for the Atlanta, Philadelphia, and Santa Ana centers state that HUD may reject the reviews if more than 10 percent of them contain significant errors or omissions (e.g., incorrect ratings given or significant issues not identified) and that an error rate of over 10 percent may be considered failure to perform. The corresponding percentages in the Denver center's contracts are 20 percent.

We found that the Atlanta, Denver, and Philadelphia homeownership centers did not track the percentage of the contractors' work that contained significant errors and omissions. Without this information, these centers were not in a position to provide the contractors with adequate performance feedback or, if necessary, to enforce the contracts' performance clauses. The Santa Ana homeownership center's evaluations of one of its two technical review contractors revealed an error rate of over 20 percent for the 5-month period from April through August 1999—double the center's acceptable rate. However, the center did not hold the contractor responsible for the high error rates, as provided for by the contract. In October 1999, the center began to intensively monitor both of

[8] Virtually all of the Atlanta, Santa Ana, and Denver centers' technical reviews are performed by contractors. In contrast, Philadelphia center officials said that their own staff performed about one-third of the center's reviews in fiscal year 1999. At the time of our review, the Santa Ana and Denver centers each had two firms under contract, while the Atlanta and Philadelphia centers each used a single contractor. The total annual value of the centers' technical review contracts is about $2 million.

its contractors in order to provide the contractors with detailed feedback and to more aggressively enforce the contracts' performance clauses. At the time of our review, all four centers indicated that they were planning to adopt a database system developed by the Denver center to, among other things, capture and track the results of their evaluations of the technical review contractors' work.

## Efforts to Hold Lenders Accountable for Poor Performance Have Not Been Sufficient

To hold lenders accountable for program violations or poor performance, HUD may (1) suspend their direct endorsement authority, (2) terminate their loan origination authority through its Credit Watch program, or (3) take enforcement action through its Mortgagee Review Board. However, the homeownership centers have made only limited use of their ability to suspend the direct endorsement authority. And while HUD's Credit Watch program is designed to hold lenders accountable for excessive loan defaults and insurance claims on FHA-insured mortgages, the program focuses on lenders who originated the troubled loans and has not held accountable other FHA lenders who underwrote and approved the loans. Furthermore, the Department's authority to implement the program is also facing a legal challenge, leaving the future of the program in doubt. Lastly, HUD's Mortgagee Review Board often takes over a year to impose sanctions against lenders for program violations.

### Homeownership Centers Made Limited Use of Their Ability to Suspend Lenders' Direct Endorsement Authority

HUD's homeownership centers have made limited use of their ability to suspend the direct endorsement authority of lenders that fail to comply with FHA's program requirements. The centers suspended a total of eight lenders in fiscal year 1999, but our analysis of HUD's technical review ratings for fiscal year 1999 showed frequent noncompliance by lenders with FHA's requirements, indicating that many additional lenders may be candidates for this action. By not suspending poorly performing lenders, HUD leaves itself vulnerable to lending practices that increase the Department's insurance risk.

HUD's guidance allows the homeownership centers to suspend the direct endorsement authority of lenders that fail to comply with FHA's program requirements but provides only general guidelines for determining which lender's direct endorsement authority should be suspended. For example, the guidance states that the centers should consider suspending lenders that exhibit "patterns" of noncompliance, but it does not define what would constitute a pattern. Lenders whose direct endorsement authority is suspended must submit their mortgage case files to the centers, which evaluate the lenders' underwriting decisions before deciding whether to insure the loans. The lenders must follow this procedure until HUD's evaluations of the case files indicate that the lenders have demonstrated satisfactory performance in underwriting loans. Lenders that cannot demonstrate satisfactory performance may have their direct endorsement authority withdrawn by the centers.

Among the four homeownership centers, we found that the Philadelphia center was the only one that had suspended the direct endorsement authority of any lenders during fiscal year 1999. Specifically, the Philadelphia center took this action against eight lenders in fiscal year 1999, citing underwriting violations identified by technical reviews or lender reviews. While the Santa Ana center did not suspend any lender's direct endorsement authority, in October 1999, the center warned 27 lenders that it might do so if they did not submit plans to eliminate and prevent the recurrence of underwriting deficiencies revealed in technical reviews. The Denver and Atlanta centers did not suspend any lender's direct endorsement authority. Officials at these centers told us they had concerns about the additional workload associated with suspending lenders and lacked the information systems necessary to evaluate lenders' performance. The centers have taken steps to address these problems, as follows:

- In September 1999, the Atlanta center hired a contractor to evaluate the underwriting decisions of lenders whose direct endorsement authority may be suspended by the center in the future. Officials at the Atlanta center said they lacked sufficient underwriting staff to do this function themselves.
- Denver center officials said they were developing a database system to, among other things, help all four centers better track and analyze the results of technical reviews and identify poorly performing lenders for enforcement actions. Although technical review ratings are entered into CHUMS, this system is a limited monitoring tool because it does not capture the reason for each rating—information that center officials believe is necessary to justify enforcement actions against lenders.

We also found that the centers had not developed consistent criteria for suspending lenders' direct endorsement authority. For example, the Philadelphia center suspended several lenders because, according to center officials, the lenders received "fair" or "poor" ratings for underwriting in over half of their technical reviews in fiscal years 1998 and 1999 and had above-average default rates on their FHA-insured mortgage loans. In contrast, the Santa Ana center proposed suspending lenders solely because the lenders' underwriters received six or more "poor" ratings in technical reviews conducted during July through September 1999, regardless of the number of reviews the lenders received during the period. Neither the Atlanta nor the Denver center had developed criteria for suspending lenders' direct endorsement authority.

Although HUD's homeownership centers suspended the direct endorsement authority of relatively few lenders in fiscal year 1999, our analysis of HUD's technical review ratings for fiscal year 1999 showed frequent noncompliance by lenders with FHA's requirements, indicating that many lenders may be candidates for this action. Specifically, our analysis showed that in fiscal year 1999, about 5,000 lenders received technical review ratings for mortgage credit analysis for the FHA-insured mortgages they originated and underwrote.[9] Nearly 20 percent of the loans subject to technical reviews received "poor" ratings for mortgage credit analysis, meaning that the lenders made mistakes in evaluating the borrowers' credit worthiness that significantly increased HUD's insurance risk. We identified 206 lenders nationwide that, during fiscal year 1999, received "poor" ratings for mortgage credit analysis on more than 30 percent of their reviewed loans and whose percentage of "poor" ratings, on the basis of statistical analysis, could have been expected to exceed 30 percent, had HUD reviewed all of their fiscal year 1999 loans.[10] Of these lenders, 131 made 10 or more FHA-insured loans in fiscal year 1999. HUD's guidance does not define the extent of noncompliance with FHA's underwriting requirements that would warrant the suspension of a lender's direct endorsement authority. However, in our opinion, the extent of noncompliance demonstrated by these 131 lenders indicates that they may be candidates for this action. As of October 1, 1999, HUD's homeownership centers had not suspended any of these lenders' direct endorsement authority.

[9]Lenders could have been counted more than once if they underwrote FHA-insured mortgages in more than one HUD field office jurisdiction. The lenders made a total of 111,699 mortgage loans that received technical reviews from HUD.

[10]Our statistical analyses identified, at the 95-percent level of confidence, those lenders that we would have expected to receive "poor" ratings on at least 30 percent of their loans, had all of their fiscal year 1999 loans been subject to technical reviews.

## Lenders Underwriting Loans Originated by Others Escape Responsibility for Excessive Default and Claim Rates Under HUD's Credit Watch Program

HUD's Credit Watch program is an enforcement tool that the Department has used to terminate the loan origination authority of lenders with excessive default and claim rates on FHA-insured loans. However, because the program's regulations pertain only to the lenders that originated the troubled loans, HUD does not always hold accountable those lenders that underwrote and approved the loans. For example, 18 of the 33 lenders whose loan origination authority was terminated by HUD during the first round of Credit Watch used other FHA lenders to underwrite all or virtually all of the troubled loans that the 18 lenders originated. However, HUD did not hold the lenders that underwrote these loans accountable. In addition, a legal challenge to HUD's authority to implement the program leaves the program's future in doubt.

In May 1999, HUD announced that it would begin to use its Credit Watch program to sanction lenders with excessively high loan default and claim rates. HUD planned to terminate the loan origination authority of any lender whose default and claim rates on mortgages insured by FHA during the preceding 24 months exceeded both the national average and 300 percent of the average rate for the HUD field office serving the lender's geographic location. Similarly, HUD planned to place on "Credit Watch" status the lenders whose default and claim rates exceeded both the national average and 200 percent of the corresponding HUD field office average. While on Credit Watch status, the lender can continue to originate FHA-insured loans, but its performance receives greater scrutiny from HUD.

As of the end of January 2000, HUD had analyzed lenders' default and claim rates for the three 24-month periods ending on March 31, 1999, June 30, 1999, and September 30, 1999. HUD limited its analyses to lenders that had a minimum of 25 defaults or claims during these periods. This program has resulted in the Department's actual or proposed termination of 50 lenders' loan origination authority and the placement of 104 additional lenders on Credit Watch status. (See table 1.)

**Table 1: Results of the First Three Rounds of HUD's Credit Watch Program**

| Credit Watch round | Number of lenders whose FHA loan origination authority was terminated by HUD | Number of lenders that HUD placed on Credit Watch status |
|---|---|---|
| 1 | 33 | 56 |
| 2 | 5 | 25 |
| 3 | 12[a] | 23 |
| Total | 50 | 104 |

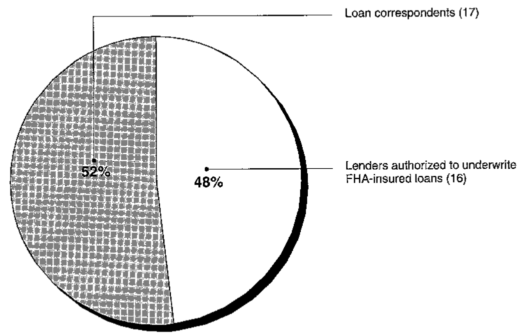
[a]Proposed as of February 1, 2000.

Source: HUD's Office of Lender Activities and Program Compliance.

The regulations governing HUD's Credit Watch program allow the Department to hold accountable for excessive defaults or insurance claims the lenders that originated the troubled loans. However, the regulations do not address HUD's authority to also hold accountable those lenders that have underwritten the loans. When originating mortgage loans, lenders perform such functions as accepting mortgage applications and obtaining employment verifications and credit reports on the borrowers. When underwriting mortgage loans, lenders use this information to determine whether borrowers are able to make their mortgage payments and whether the loans should be approved. HUD officials told us they recognized that the underwriting lenders contributed to excessive defaults and insurance claims but that the Credit Watch program's regulations did not permit them to take enforcement actions against these lenders. The officials said they were considering regulatory changes to address this problem.

The results of the first round of the Credit Watch program illustrate the program's limitations as an enforcement tool. As shown in figure 7, of the 33 lenders that HUD terminated during the first round of the program, 17 were loan correspondents. Under HUD's regulations, loan correspondents sell or transfer loans that they originate to other FHA lenders, known as sponsoring lenders, for underwriting and approval. Sponsoring lenders underwrote the nearly 6,200 loans that the 17 loan correspondents originated and FHA insured during the 24-month period of analysis, but HUD did not impose sanctions against the sponsoring lenders through the Credit Watch program. The remaining 16 lenders had the authority to underwrite FHA-insured loans. However, 1 of these 16 lenders relied largely on other lenders to underwrite the loans it originated. Specifically, HUD's data showed that other lenders underwrote 364 of the 365 loans that the lender had originated and FHA insured during the 24-month period. The data showed further that three lenders had underwritten 274 of these 364 loans and that the lenders' default and claim rates for these loans were 6 to 13 times the national average and 3 to 6 times the corresponding HUD field offices' averages. Nevertheless, the three lenders were not subject to enforcement actions under the Credit Watch program.

**Figure 7: Percentage of Lenders, by Type, Whose Loan Origination Authority Was Terminated Because of Excessive Defaults and Insurance Claims on Loans Made For the 24-Month Period Ending March 31, 1999**




Source: GAO's analysis of data from HUD.

In September 1999, one lender whose authority to originate FHA-insured mortgage loans was terminated by HUD filed a lawsuit seeking to overturn HUD's actions. Among other issues, the lender contended that HUD had exceeded its statutory authority when it issued its Credit Watch regulations and that the manner in which HUD terminated the lender's authority had deprived the lender of due process. In October 1999, a federal district court ruled that HUD's Credit Watch regulations were invalid and set aside HUD's termination of the lender. The court stated that HUD's statutory authority requires that after determining that a lender has excessive defaults and claims, HUD must provide the lender the opportunity to provide the Department with a plan and timetable for correcting the defaults. The court stated that HUD had sidestepped its statutory mandate by enacting regulations that allowed the Department to terminate a lender's authority to originate loans whenever HUD deemed it appropriate because of the lender's default and claim rates. The court also concluded that even if HUD had the authority to issue such regulations, the regulations denied the lender its right to due process.[11] In December 1999, the same court ruled that its October 1999 decision did not affect the other lenders whose FHA's loan origination authority was terminated by HUD.

HUD has appealed this decision. An Assistant General Counsel in HUD's Litigation Division told us that, in HUD's view, the National Housing Act provides the Department with broad authority to issue regulations and fashion programs for dealing with lenders with excessive default and claim rates. According to this official, HUD also disagrees with the court's contention that HUD's regulations denied the lender due process. He said that the lenders whose authority HUD proposed to terminate were given 30 days written notice of HUD's intention and were provided the opportunity to explain the reasons for the high default and claim rates. HUD officials told us that if the Department loses its appeal of the court decision, it will seek legislation that authorizes HUD to continue the Credit Watch program.

## Mortgagee Review Board's Process for Sanctioning Lenders Is Time-Consuming

HUD's Mortgagee Review Board (Board) can impose administrative actions against FHA lenders that commit program violations. However, the Board frequently takes over a year to impose sanctions against lenders and faces challenges to improving its timeliness. As a result, some of these lenders continue making FHA-insured loans for a year or more before they are held accountable for the violations.

[11] *Capitol Mortgage Bankers, Inc. v. Cuomo*, 77 F. Supp. 2d 690 (D. Md. 1999).

In fiscal year 1999, 68 cases were referred to the Board for action. The majority of the cases referred to the Board are the result of lending violations revealed in lender reviews performed by HUD's homeownership centers and involve lenders that make mortgages for single-family homes. Once the Board reviews and accepts a referral, it sends the lender a notice of violation that provides the lender 30 days to respond in writing to the Board. After reviewing the lender's response, the Board decides what actions to take. The Board may impose a number of sanctions against FHA-approved lenders, ranging from a letter of reprimand to withdrawal of a lender's FHA approval.

The majority of the Board's actions result in settlement agreements, which require lenders to indemnify improperly originated loans, pay fines, and/or take actions to prevent future lending violations. For example, we reviewed the Board's records for 24 of the 30 cases involving single-family housing lenders that the Board acted on from October 1998 through April 1999.[12] As of November 1999, we found that in 18 of the 24 cases, the Board had either reached settlement agreements with the lenders (5 cases) or was still attempting to reach settlement agreements (13 cases). In the remaining six cases, the Board had withdrawn the lenders' FHA approval. (See table 2.)

Our analysis of the 24 cases further showed that the Board's efforts to review the cases and impose sanctions against lenders or to enter into settlement agreements with them is frequently a time-consuming process. As table 2 shows, for the 11 cases that the Board completed action on as of November 1999, it took an average of 8.5 months from the notice of violations to withdraw lenders' FHA approval and an average of 11.2 months to reach settlement agreements. For one of the withdrawals and for two of the settlement agreements, the Board took over a year to complete these actions. For the 13 cases that the Board had not completed action on, an average of 14.3 months had elapsed since the Board sent the lenders notices of violation. The length of time required by the Board to complete its actions in these 13 cases has allowed some of these lenders to continue making FHA-insured loans for over a year without being held accountable for their violations. For example, in April 1998, the Board sent a notice of violation to one of these lenders because the lender committed several

[12]The records for the remaining six cases were being used by HUD staff and were not available for our review (three cases) or our preliminary review indicated that the cases did not involve single-family mortgage loans (three cases). As of November 1999, the official minutes of the Board's meetings during fiscal year 1999 were available only for the period covering October 1998 through April 1999.

violations, including using false information to originate loans. However, the Board had not resolved the case as of November 1999—19 months later—and during the 19-month period, the lender made over 300 FHA-insured mortgage loans.

**Table 2: Summary of the Mortgagee Review Board's Fiscal Year 1999 Actions on 24 Cases as of November 1999**

| Type of Board action | Number of cases | Average number of months elapsed since the notices of violation |
|---|---|---|
| Board action completed | | |
| Lender's FHA approval was withdrawn | 6 | 8.5 |
| Lender entered into a settlement agreement | 5 | 11.2 |
| Board action ongoing | | |
| Board and lender attempting to reach a settlement agreement | 13 | 14.3 |
| **Total** | 24 | |

Source: GAO's analysis of data from HUD.

HUD does not have guidelines for the time it should take for the Board to take enforcement actions against lenders. However, the Board recognizes that its review process and its efforts to impose sanctions against or enter into settlement agreements with lenders that commit program violations can be time-consuming. The Board has taken some steps to speed up the process. For example, the Board's secretary told us that in December 1998, the Board adopted a policy of meeting every 2 months to consider case referrals. This official told us that prior to adopting this policy, the Board did not have an established meeting schedule and met only whenever a sufficient number of cases had accumulated for review. Also, the Board recently hired another person to help the Board's secretary review case referrals and prepare the cases for the Board's action. In addition, to speed up the settlement agreement process, the Board plans in future violation letters to ask the lenders whether they would be willing to settle their cases and, if so, under what terms and conditions. If a lender's settlement offer was acceptable to the Board, a settlement agreement could be prepared and signed immediately. If a lender's offer was not acceptable, the Board could then make its own proposal for settling the case.

## Conclusions

FHA insures tens of billions of dollars in mortgages for single-family homes each year. While FHA's Mutual Mortgage Insurance Fund is currently financially healthy, poor lending practices could adversely affect the Fund's financial position. Because lenders underwrite virtually all FHA-insured mortgages without HUD's prior review, it is important for HUD to hold lenders accountable for the quality of these loans. However, HUD has not taken adequate steps to maximize the effectiveness of its oversight resources and minimize its insurance risk. Weaknesses in HUD's approval, monitoring, and enforcement efforts point to the need for improvements in HUD's oversight of FHA mortgage lenders.

HUD could significantly improve its process for approving lenders seeking the authority to underwrite FHA-insured loans. Because the Department lacks clear and specific standards for granting lenders direct endorsement authority, its homeownership centers have implemented the existing standards differently and approved lenders that demonstrated varying levels of proficiency, including lenders that made multiple and serious underwriting mistakes. Consequently, HUD has only limited assurance that the lenders it is approving are qualified to underwrite loans and, therefore, may be exposing the Department to unreasonable insurance risks. Addressing this deficiency is especially important, given that since 1996, HUD has no longer individually reviewed the qualifications of lenders' underwriting staff.

Contrary to HUD's guidance, the homeownership centers' monitoring of lenders does not adequately focus on the lenders and loans that pose the greatest insurance risks to the Department. Focusing on high-risk cases would increase HUD's opportunities to uncover and curtail improper lending practices. However, HUD's homeownership centers often have not conducted lender reviews of the lenders considered to pose the highest risk, and HUD lacks a systematic process for identifying and prioritizing such lenders for review. Furthermore, HUD's centers have not consistently targeted for technical reviews either high-risk loans or loans made by problem lenders and newly approved lenders. In addition, HUD's oversight of contractors that perform technical reviews does not provide adequate assurance that the contractors are doing a good job. Because of these deficiencies, HUD's lender reviews and technical reviews are not as effective as they could be in mitigating financial losses to the Department.

HUD has not taken sufficient steps to hold lenders accountable for poor performance and program violations. Numerous lenders are not complying with FHA's underwriting requirements, yet HUD's homeownership centers have suspended the direct endorsement authority of relatively few lenders. Furthermore, HUD's Credit Watch program is a strong enforcement tool but a court decision has left the future of the program in doubt. In addition, we believe that the program would be more effective if it held accountable all the lenders involved in making problem loans rather than just those that originated the loans. When poorly performing lenders are not held responsible, they may continue to make loans that increase potential losses to FHA's insurance fund.

## Recommendations

To reduce the financial risks assumed by FHA and to improve HUD's oversight of FHA mortgage lenders, we recommend that the Secretary of HUD direct the Assistant Secretary for Housing-Federal Housing Commissioner to do the following:

- Improve the process for granting lenders direct endorsement authority by developing specific standards for overall acceptable performance in preclosing reviews and ensuring that the homeownership centers comply with these standards.
- More effectively monitor lenders' performance by
  - developing procedures to identify and prioritize high-risk lenders for lender reviews and ensuring that the homeownership centers consistently apply these procedures;
  - developing procedures and enhancing FHA's management information systems to identify and select, for technical reviews, loans and lenders within each homeownership center's jurisdiction that pose a high insurance risk to the Department;
  - complying with guidance to perform technical reviews of all the FHA-insured loans that are made by lenders that are newly granted direct endorsement authority; and
  - tracking the performance of contractors conducting technical reviews against performance standards in the contracts and taking appropriate actions against contractors whose performance is not acceptable.
- Strengthen its enforcement efforts by clarifying and implementing guidelines for identifying lenders whose direct endorsement authority should be suspended.

In addition, we recommend that once the legal basis of the Credit Watch program is resolved, the Secretary of HUD direct the Assistant Secretary for Housing-Federal Housing Commissioner, to revise the Credit Watch program's regulations to cover lenders that underwrite FHA-insured loans with excessive default and claim rates as well as those lenders that originate such loans.

## Agency Comments

We provided HUD with a draft of this report for review and comment. HUD stated that while it did not always agree with the report's characterization of the Department's practices and procedures for overseeing FHA lenders, it generally agreed with the report's recommendations.

In commenting on the draft report's discussion of technical reviews of loans, HUD took issue with our statement that its selection of loans for review was not based on risk. HUD stated that it performs technical reviews of all Section 203(k) rehabilitation loans, mortgages made to nonprofit agencies, and other categories of mortgages that historically have had higher default rates. Our report recognizes that the homeownership centers have, on a limited basis, targeted some high-risk loans for technical reviews. At the same time, the centers' lack of information systems capable of identifying high-risk loans makes it impractical for the centers to select and review high-risk loans on a routine basis. Furthermore, the categories of loans cited by HUD—Section 203(k) loans and mortgages made to nonprofit agencies—account for a very small portion of FHA's loan portfolio.

HUD also disagreed with our finding that it was not monitoring the performance of technical review contractors. Our draft report did not present such a finding. Rather, we observed that three of the four homeownership centers did not track the percentage of the contractors' work that contained significant errors and omissions and, therefore, were not in a position to provide the contractors with adequate performance feedback or, if necessary, to enforce the contracts' performance clauses.

HUD commented that our draft report's discussion of lender reviews did not adequately recognize that its targeting guidance requires homeownership center staff to consider several factors, in addition to lenders' default and claim rates, in selecting lenders for review. Our report recognizes that HUD's guidance requires that various risk factors, such as lenders' loan volume and the late payment of mortgage insurance premiums to HUD, be considered in targeting lenders for review. However, our concern is that the guidance neither indicates how these factors should weighted nor how lenders should be prioritized. As a result, the homeownership centers have not targeted lenders for reviews in a consistent manner.

While agreeing with our recommendation to clarify and implement guidelines for identifying lenders whose direct endorsement authority should be suspended, HUD disagreed with the draft report's finding that the Department had made limited use of its ability to suspend the direct endorsement authority of lenders. HUD stated that while the homeownership centers had not actually suspended the authority of many lenders, they had threatened suspension in several dozen cases every year in an attempt to improve lenders' performance. As our report notes, one center suspended 8 lenders in fiscal year 1999 and another center threatened to suspend 27 lenders in October 1999. At the other two centers, we found only one instance in which the center threatened to suspend the authority of a lender. Taken together, the actions of the four centers do not appear to support HUD's assertion that the centers have routinely used the threat of suspension to improve lenders' performance.

Finally, while HUD agreed with our recommendation to revise its Credit Watch program to hold loan underwriters accountable for excessive default and claim rates, HUD did not believe that it would be appropriate to stop taking enforcement action against loan originators. We did not intend for HUD to stop taking enforcement action against loan originators but rather that the Credit Watch program hold both the lenders that originated the troubled loans and the lenders that underwrote the loans accountable for excessive default and claim rates because both share responsibility for the quality of the loans.

The full text of HUD's letter is presented in appendix I.

We conducted our work at HUD's headquarters and its Atlanta, Denver, Philadelphia, and Santa Ana homeownership centers. Our review focused on the adequacy of HUD's policies and procedures for overseeing lenders. We reviewed regulations, handbook guidance, and other documents related to HUD's approval, monitoring, and enforcement activities for FHA lenders. We interviewed officials from HUD's Office of Insured Single-Family Housing, Enforcement Center, Mortgagee Review Board, and the four centers. We also interviewed representatives from Fannie Mae, Freddie Mac, and a firm contracted by HUD to perform technical reviews. In addition, we performed limited tests and analyses to determine whether HUD's policies and procedures were properly utilized to limit the

Department's insurance risk. We analyzed information on the performance of all 36 lenders granted direct endorsement authority by the four homeownership centers in the 6 months prior to our 1999 visits. We also reviewed documentation from the centers pertaining to targeting of lenders for on-site monitoring and technical reviews, the oversight of technical review contractors, and enforcement actions against lenders. We analyzed data from HUD's Computerized Homes Underwriting Management System to determine how frequently lenders received "poor" ratings for mortgage credit analysis in technical reviews. We determined the number and types of lenders sanctioned by HUD under its Credit Watch program as of the end of January 2000. Finally, we reviewed the Mortgagee Review Board's files for information on its enforcement activities. We performed this review from June 1999 through April 2000 in accordance with generally accepted government auditing standards. Appendix II provides additional details on our scope and methodology.

As arranged with your office, unless you publicly release its contents earlier, we plan no further distribution of this report until 30 days after the date of this letter. At that time, we will send copies to the Honorable Barney Frank, Ranking Minority Member, Subcommittee on Housing and Community Opportunity, House Committee on Banking and Financial Services; the Honorable James A. Leach, Chairman, and the Honorable John J. LaFalce, Ranking Minority Member, House Committee on Banking and Financial Services; the Honorable Carl Levin, Ranking Minority Member, Permanent Subcommittee on Investigations, Senate Committee on Governmental Affairs; the Honorable Phil Gram, Chairman, and the Honorable Paul S. Sarbanes, Ranking Minority Member, Senate Committee on Banking, Housing, and Urban Affairs; and the Honorable Fred Thompson, Chairman, and the Honorable Joseph Lieberman, Ranking Minority Member, Senate Committee on Governmental Affairs. We will also send copies of this report to the Honorable Andrew M. Cuomo, Secretary of HUD; the Honorable William C. Apgar, HUD Assistant Secretary for Housing-Federal Housing Commissioner; and the Honorable Jacob J. Lew, Director, Office of Management and Budget. We will make copies available to others upon request.

Please call me on (202) 512-7631 if you or your staff have any questions about this report. Major contributors to this report are listed in appendix III.

Stanley J. Czerwinski

Stanley J. Czerwinski
Associate Director, Housing and Community
Development Issues

Appendix I

# Comments From the Department of Housing and Urban Development

U. S. Department of Housing and Urban Development
Washington, D.C. 20410-8000

APR 14 2000

OFFICE OF THE ASSISTANT SECRETARY
FOR HOUSING-FEDERAL HOUSING COMMISSIONER

Mr. Stanley J. Czerwinski
Associate Director, Housing and Community Development Issues
United States General Accounting Office
Washington, D.C. 29548

Dear Mr. Czerwinski:

Thank you for the opportunity to comment on your report entitled Single Family Housing: Stronger Oversight of FHA Lenders Could Reduce HUD's Insurance Risk (GAO/RCED-00-112). HUD is proud of the tremendous progress we have made in putting much greater organizational emphasis and resources on lender monitoring and enforcement activities. Since 1997, HUD has increased the number of lender monitors from approximately 23 to more than 140, and the number of annual lender monitoring reviews from approximately 220 to more than 900. Over the last two years, FHA also has developed two new powerful technological systems to assess lender default and claim rates – FHA's Neighborhood Watch/Early Warning System, a web-based application that tracts lender default and claim rates by census track, and the Mortgagee Portfolio Analysis Subsystem (MPAS), which tracks default and claim rates by lender for 81 regions. Using analysis generated through these systems, FHA also has implemented Credit Watch, a powerful new enforcement tool that in just nine months of operation has terminated or proposed termination of 68 lenders and put another 140 on probationary status.

Moreover, all recent independent, non-partisan analysis of the financial condition of the FHA indicate that these new programs and resource investments are paying off. FHA's 1999 Actuarial Review performed by Deloitte & Touche indicated that:

- The **economic value of the fund** – a measure of the value of projected premium payments for current insurance in force less estimated claim payments and expenses – stands at an **all-time record high of $16.637 billion, an increase of $5.277 billion from the economic value as reported for FY98.** The Actuarial studies show that this improvement is due to fundamental changes in FHA, not simply recent economic prosperity, and will withstand future economic downturns. This is a remarkable turnaround from just ten years ago, when the FHA MMI Fund had an economic value of **negative $2.7 billion in 1990.**

- Furthermore, the Review indicates that FHA's MMI Fund **capital ratio** -- defined as the economic value of the fund divided by the total insurance in force -- is 3.66 in FY 1999, a dramatic increase over the FY 1998 capital ratio of 2.71 percent, and well in excess of the Congressional mandate to exceed a benchmark ratio of 2.00 by the year 2000.

Still, in spite of this progress, FHA appreciates many of GAO's recommendations for ways to enhance and more fully document existing monitoring procedures. While in many cases HUD does not agree with GAO's characterization of current practices and procedures, we do agree with many of the recommendations included in the report.

GAO Response—Oversight of Lenders

FHA's comments on specific statements and recommendations in the report follow:

**GAO Statement**: Standards for Granting Endorsement Authority Are Not Adequately Defined and Recently Approved Lenders Varied in Their Performance in Preclosing Reviews

FHA's existing guidance for the process of approving new lenders for Direct Endorsement (DE) authority clearly identifies the number of loans to be re-underwritten and graded by HOC staff, and it sets clear underwriting standards to be applied in grading lender performance. This guidance currently is widely followed by HOC staff. However, determining the appropriate overall rating of an individual lender's performance and making the final approval decision necessarily requires some judgment on the part of HOC management. For example, even within loans rated as "poor" the nature of the deficiency can range from egregious disregard for underwriting standards to a failure to follow FHA documentation requirements due to a lack of familiarity with HUD guidelines. Moreover, HOC staff pay close attention to whether a new lender shows progress over time in their underwriting performance in response to FHA feedback and guidance. Therefore, it is not appropriate to rely solely on a numeric evaluation, in the complete absence of judgment, in making the final DE approval decision.

Still, HUD generally agrees with GAO's conclusion that the process for determining DE eligibility would benefit from more detailed HUD Headquarters (HQ) guidance on what constitutes overall acceptable performance. Within the next 60 days HUD will develop additional procedures that will establish a minimum number of good and fair ratings necessary for a lender to receive DE approval, and clearly identify requirements for additional acceptable test cases to be submitted should the first 15 not reach a satisfactory score. The procedures will also put greater weight on the more recent submissions since the lender is expected to learn from its mistakes. Although HOC staff currently consistently follow the same process for grading individual loan underwriting, this additional guidance will ensure greater consistency in the basis for making final approval decisions. In addition, HUD will also retain the right to withhold DE approval from any lender if in the opinion of management that lender has not earned the right to participate as a full DE lender.

Finally, it is important to note that FHA has very clear field guidance requiring HOC staff to review loans originated by newly approved lenders at the 100 percent level for the first 50 cases or 180 days, whichever comes first. This requirement allows FHA staff to closely monitor the lender's performance immediately following DE approval. This 100 percent review requirement was recently reiterated to management in the four HOCs.

**GAO Statement**: Selection of Loans for Technical Reviews Was Not Based on Risk

It is not accurate to state that FHA's selection of mortgages for technical reviews is not a function of the perceived risk of those loans. As a business practice, FHA reviews all Section 203(k) rehabilitation loans, mortgages made to nonprofit agencies, and other categories of mortgages that have historically had higher default rates. Further, while GAO may criticize FHA for its method of targeting by loan type, FHA believes that targeting technical reviews by **lender** performance makes more sense and produces greater results.

GAO Response—Oversight of Lenders

Moreover, FHA has now implemented the new ACCESS Technical Review Reporting System which tracks results of all technical reviews by lender. ACCESS is designed to capture specific errors in five review categories including mortgage credit analysis and property value assessment, and it also has the ability to track risk characteristics such as secondary financing, "gifted" downpayment sources, and other loan application variables thought to be associated with insurance risk. This data base is extremely flexible in its reporting capability and can produce ad-hoc reports by lender, underwriter, type of error, contract reviewer and loan rating. Such ad-hoc reports can serve as a valuable tool to select specific cases and/or lenders for a higher percentage of post-endorsement reviews. In selecting loans for technical review, FHA HOC staff currently examine the individual **lender's** performance by using two measures to determine if additional review action is warranted. First, FHA's Processing and Underwriting Division (P&U) primarily focuses on lenders' underwriting performance by examining the new ACCESS Technical Review Reports to determine which lenders are receiving an unusually high number of poor or fair ratings. If a lender appears on the list as having a considerable volume of less-than-good ratings, the next action is to consult Neighborhood Watch (NW) to determine if the deficient underwriting performance is also resulting in loan defaults.

If a lender is performing unsatisfactorily based on its ratings profile, the HOC analyzes the degree of risk created and resets the percentage of loans to be reviewed above the routine 10% level. The HOC then monitors the results of the additional underwriting reviews via ACCESS to determine if further action should be taken, possibly including an increased percentage of reviews, termination of DE authority, etc.

Second, Neighborhood Watch is used as an *initial* source of information to determine if an increased percentage of technical reviews of a lender should be required. Underwriting reviews per se do not always give definitive information on a lender's underwriting performance, but a rising default rate is cause for further scrutiny.

Moreover, when the default rate is significantly higher than the area average FHA targets the poorest performing lenders are targeted for 100% technical reviews. It is at this point that the HOCs send letters to these poorly performing lenders advising them of the high number of poor and fair ratings and the need for improved performance. The correspondence advising the lender of poor underwriting performance, also cites the NW default data to give them an idea of how they compare with other lenders in the same geographic area.

With the ACCESS database we are now monitoring the results of the reviews to learn if performance improves. If a lender continues to submit poorly-rated cases, then various sanctions, including termination of the lender's DE status, are proposed and communicated to the lender.

It should also be pointed out that FHA has developed a mortgage scorecard that accurately and immediately assesses the risk on a mortgage. Once deployed, FHA will have information on each loan as it enters the endorsement stream. From this information, we can determine which loans contain risk indicators and, thus, are candidates for post-endorsement technical reviews.

GAO Response—Oversight of Lenders

**GAO Statement**: Lender Reviews Increased but Were Often Not of Riskiest Lenders

As GAO noted in the report, FHA has put tremendous organizational emphasis on enhanced lender monitoring over the last three years. Since 1997, the Department has increased the number of lender monitors from 23 to more than 140, and the number of annual reviews from approximately 220 to more than 900. As part of this greater emphasis on monitoring GAO also notes that FHA has clear guidance requiring targeting of high risk lenders for on-site monitoring reviews. The guidance clearly identifies risk assessment factors to be used in selecting lenders for review. All FHA Quality Assurance Division (QAD) staff have been thoroughly trained in the guidance and risk factors to be used.

Furthermore, over the last two years FHA has developed two new technological systems to assess lender default and claim rates – FHA's Neighborhood Watch/Early Warning System, a web based application that tracts lender default and claims by census tract, and the Mortgagee Portfolio Analysis Subsystem (MPAS), which tracks default and claim rates by lender for 81 geographic regions around the country and provides all analysis used to administer HUD's new Credit Watch Program. All QAD staff also have been trained in the use of the Neighborhood Watch/Early Warning System, and they have access to data produced by MPAS.

What GAO fails to completely recognize however, is that FHA's targeting guidance also requires QAD staff to consider several other factors, in addition to the lender's default and claim rate, in selecting lenders for review. Specifically, FHA's guidance requires that the following risk factors be included in targeting reviews: early default and claim rate, late payment on upfront mortgage insurance premiums, level of use of high risk loan programs, length of time since the last review, complaints from the public, state consumer regulatory agencies or other partners, and frequency of underwriting irregularities noted in technical reviews. All of these factors inform FHA's targeting decisions – not exclusively the lender default and claim rate, as GAO seems to imply.

Moreover, the evidence indicates that factors other than lender default and claim rate are very effective targeting tools. For instance, taken together, on-site monitoring reviews of lenders selected for reasons other than exclusively a high default and claim rate in FY1999 produced the following results:

| | Signed Indem. Agreements | MRB Refer | OIG Refer | Sus/ Debar Refer | LDP Refer |
|---|---|---|---|---|---|
| HOC | | | | | |
| Santa Ana | 91 | 18 | 3 | 3 | 17 |
| Denver | 331 | 18 | 6 | 1 | 5 |
| Philadelphia | 358 | 18 | 37 | 12 | 9 |
| Atlanta | 310 | 16 | 57 | 16 | 29 |

Taken together, these reviews resulted in 1,090 loan indemnifications representing savings to FHA of nearly $35 million, almost three times as many loan indemnifications as FHA produced in all the reviews conducted in FY 1998 (454 indemnifications, with savings of just $13.2 million in FY1998).

GAO Response—Oversight of Lenders

Still, FHA recognizes that it would benefit from more clearly **documenting** loan monitoring targeting decisions. That is why we have developed more detailed targeting procedures that require all QAD Directors and Branch Chiefs to uniformly use the Neighborhood Watch system to identify lenders with high early default and claim rates, evaluate other risk factors included in the guidance, and clearly document all targeting decisions and assignments. This more detailed approach already has been implemented by all four HOCs, and will be tested through the third quarter of this fiscal year, and finalized at the start of the fourth quarter.

Further, the Office of Lender Activities and Program Compliance in HUD HQ will monitor the implementation of the targeting methodology with the receipt of a standard report from each HOC, which will be received at least quarterly. This report will identify the lenders targeted for the quarter along with a more detailed explanation of the rationale for targeting decisions.

**GAO Statement**: Homeownership Centers' Oversight of Technical Review Contractors was Limited

HUD disagrees with GAO's assertion that the HOC staff are not monitoring technical review contractors' performance. Each HOC re-analyzes all loans rated "poor", and reviews a sample of the loans with "good" or "fair" ratings. However, HUD does concur with GAO's suggestion that the process can be improved through automation. In the past, these contractor reviews were done through handwritten review documents. With implementation of the ACCESS Technical Review database over the last few months, HUD now captures contractor performance on missed and overturned findings. With this data, HOC staff can better determine if the contractor is performing its post-endorsement technical reviews up to HUD's standards.

**GAO Statement**: Homeownership Centers Made Limited Use of Their Ability to Suspend Lenders' Direct Endorsement Authority

FHA disagrees with GAO's assertion that the HOCs made limited use of their ability to suspend lenders' DE authority. Although it is true that the HOCs have not actually suspended many lenders' DE authority, FHA has **threatened suspension** in several dozen cases every year. In our experience the threat of suspension often has proven to dramatically improve lenders' performance. It is very common for the HOC to send a letter threatening suspension of DE status to lenders with high default and claim rates. In such cases the management of the lender typically requests and is granted an interview with HOC personnel. The lender's principal staff and underwriters then meet with the HOC underwriters and quality control staff to discuss specific examples of poor underwriting and highlight suggestions for improving performance. In the vast majority of cases, this one-on-one interaction coupled with the clear threat of suspension of DE status, results in dramatic improvements in the quality of the loan submissions to FHA. This approach – threatening loss of DE status, but then providing very specific lender feedback and suggestions for improvement – has proven to be a constructive and successful means of improving lenders' performance.

Still, FHA agrees with GAO's recommendation to further clarify the conditions under which lenders should ultimately be placed on pre-closing review, to ensure greater consistency in application of this enforcement tool across all four HOCs.

GAO Response—Oversight of Lenders

**GAO Statement**: Lenders Underwriting Loans Originated by Others Escape Responsibility for Excessive Default and Claims Rates Under HUD's Credit Watch Program (p. 22)

FHA agrees with GAO's statement that the newly developed Credit Watch System is a very powerful enforcement tool. By relying on automated analysis of lenders' early default and claim rate and simply terminating lenders with excessively high rates relative to other lenders in the same region, Credit Watch packs a powerful punch while using relatively few resources. Since launching this new program in May, 1999, HUD has terminated, or proposed termination, of 68 lender branches and placed another 140 lenders on probation. In just nine months of operation this new initiative already has taken more actions against lender branches than the Mortgage Review Board (MRB) took over the last two years. A complete summary of Credit Watch results to date appear below:

| | Round 1(5/ 99) | Round 2(9/ 99) | Round 3(1/00) | Round 4 (4/ 00) |
|---|---|---|---|---|
| Terminations | 32 Branches (26 lenders) | 5 Branches (5 lenders) | 11 Branches** (10 lenders) | 16 Branches** (15 lenders) |
| Credit Watch | 56 Branches (51 lenders) | 25 Branches (24 lenders) | 33 Branches (31 lenders) | 26 Branches (14 lenders) |

**Rounds 3 and 4 are proposed actions since, final Decisions have not been made.

In regard to GAO's criticism of the program, FHA believes it is appropriate to hold loan originators responsible for loan performance. In many respects, it is the loan originator who in taking the loan application and collecting and analyzing all necessary documentation poses the greatest risk to FHA. Therefore, FHA does not believe it would be appropriate to forego enforcement actions against the loan originator. However, FHA does agree that holding the underwriter responsible, **in addition to** the loan originator would enhance the Credit Watch System.

Sincerely,

William C. Apgar
William C. Apgar
Assistant Secretary for Housing-
Federal Housing Commissioner

GAO Response—Oversight of Lenders

Appendix II

# Objectives, Scope, and Methodology

Our objectives were to answer the following questions: (1) How well does the Department of Housing and Urban Development (HUD) ensure that lenders granted direct endorsement authority by the Federal Housing Administration (FHA) are qualified to receive such authority? (2) To what extent does HUD focus on high-risk lenders in monitoring the lenders participating in FHA's mortgage insurance programs? (3) To what extent is HUD holding these lenders accountable for poor performance? Our review focused on the adequacy of HUD's policies and procedures for overseeing lenders. We performed limited tests and analyses to determine whether these policies and procedures were properly utilized to limit HUD's insurance risk.

To determine how HUD ensures that lenders granted directed endorsement authority are qualified to receive such authority, we reviewed HUD's regulations, procedures, and other guidance relating to its process for approving lenders and granting lenders direct endorsement authority. Lenders with direct endorsement authority can underwrite and close FHA-insured mortgage loans without prior FHA review or approval. We interviewed officials from HUD's Office of Lender Activities and Program Compliance and its four homeownership centers. We developed information on the number of lenders granted direct endorsement authority by each of the four homeownership centers during the 6 months prior to our visit to each of the centers. We visited the Philadelphia center in August 1999 and the Denver, Santa Ana, and Atlanta centers in October 1999. For each of the 36 lenders approved during this time period, we reviewed documentation maintained by the centers to determine (1) the ratings that the lender received on the mortgages it submitted to the center to demonstrate its ability to comply with FHA's requirements and (2) whether the centers followed FHA's procedures in granting lenders direct endorsement program authority.

To determine the extent to which HUD is focusing its monitoring efforts on high-risk lenders, we reviewed HUD's guidance and procedures for conducting technical reviews (i.e., review of individual loans performed after approval of mortgage insurance to assess the quality of lenders' underwriting practices) and lender reviews (i.e., on-site reviews of lenders' operations by HUD staff). We determined the extent to which each of the four homeownership centers met HUD's fiscal year 1999 goals to (1) conduct technical reviews of at least 10 percent of the single-family mortgage loans insured by FHA during the fiscal year and (2) perform 225 lender reviews. We reviewed HUD's use and oversight of contractors that perform technical reviews and interviewed representatives from one contractor that was performing reviews for three of the four homeownership centers. We interviewed officials at each of the centers on a variety of issues dealing with technical reviews and lender reviews. The issues discussed included the (1) centers' criteria for targeting loans and lenders for review, (2) procedures for monitoring the work of technical review contractors, and (3) number and experience of the centers' staff who were performing lender reviews. We also interviewed representatives from Fannie Mae and Freddie Mac regarding their efforts to monitor the performance of lenders whose loans they purchase.

To determine the extent to which HUD is holding lenders accountable for poor performance, we reviewed HUD's regulations and policy guidance to determine the enforcement options available to HUD. We interviewed officials from HUD's Office of Lender Activities and Program Compliance, Enforcement Center, and Mortgagee Review Board. At each of the four homeownership centers, we discussed with cognizant officials each center's efforts to take enforcement actions against poorly performing lenders. Using data from HUD's Computerized Homes Underwriting Management System on the technical reviews conducted during fiscal year 1999, we determined the percentage of reviews that gave a "poor" rating for mortgage credit analysis. Using these same data, we performed statistical analyses to identify, at the 95-percent level of confidence, those lenders we would have expected to have received "poor" ratings on more than 30 percent of their loans, had all of their fiscal year 1999 loans been subject to technical reviews. We determined the number and types of lenders sanctioned by HUD under its Credit Watch program as of the end of January 2000. We reviewed the Board's files for 24 of the 30 cases involving single-family mortgage lenders that the Board acted on during October 1998 through April 1999 and determined the nature and status of the Board's actions as of November 1999.

Our reliability assessments of the specific data elements required for this review indicated that the data were reliable enough for our analyses. To assess reliability, we reviewed existing information about data quality and controls supporting the data systems and discussed the data we analyzed with agency officials to ensure that we interpreted them properly.

We performed this review from June 1999 through April 2000 in accordance with generally accepted government auditing standards.

# GAO Contacts and Staff Acknowledgments

## GAO Contacts

Stanley J. Czerwinski (202) 512-7631

Paul J. Schmidt (312) 220-7681

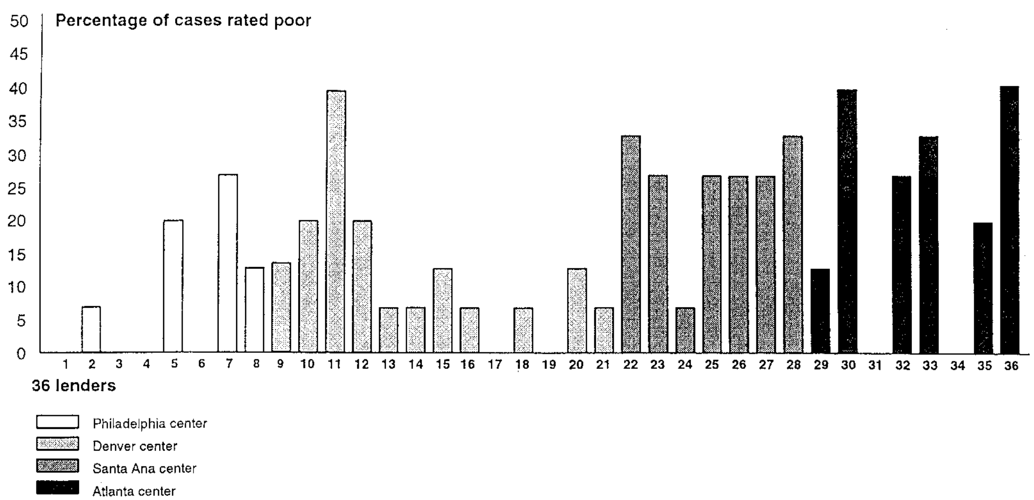
## Acknowledgements

In addition to those named above, Karen Bracey, Karin Lennon, John McGrail, Stan Ritchick, Steve Westley, and Shana Whitehead made key contributions to this report.

Senate Permanent Subcommittee
On Investigations

EXHIBIT # 8

Figure 4: Frequency of Poor Ratings for Mortgage Credit Analysis Given to 36 Approved Lenders in Their Last 15 Preclosing Reviews




Note: Our analysis included all 36 lenders to whom the four homeownership centers had granted direct endorsement authority in the 6 months prior to our visits to the centers. We visited the Philadelphia center in August 1999 and the Denver, Santa Ana, and Atlanta centers in October 1999.

Source: GAO's analysis of data from HUD's homeownership centers.

Senate Permanent Subcommittee
On Investigations

EXHIBIT # 9

# HUD's Failure to Monitor Appraisers

| Hoc Office | Appraisals Rated Poor in a Desk Review | Appraisals Rated Poor in a Desk Review But Not Field Reviewed | Percent of Poors Not Field Reviewed |
|---|---|---|---|
| Atlanta | 7,123 | 5,755 | 80.8% |
| Philadelphia | 4,641 | 4,133 | 89.1% |
| Santa Ana | 3,208 | 2,683 | 83.6% |
| Denver | 554 | 436 | 78.7% |
| Total | 15,526 | 13,007 | 83.8% |

Senate Permanent Subcommitte
On Investigations

EXHIBIT # 10

US Department of Housing
and Urban Development
Office of Housing
Federal Housing Commissioner

OMB Approval No: 2502-0538
(exp. 11/30/99)

# For Your Protection: Get a Home Inspection

Name of Buyer ______________________

Property Address ______________________

## What the FHA Does for Buyers... and What We Don't Do

**What we do:** FHA helps people become homeowners by insuring mortgages for lenders. This allows lenders to offer mortgages to first-time buyers and others who may not qualify for conventional loans. Because the FHA insures the loan for the lender, the buyer pays only a very low down-payment.

**What we don't do:** FHA does not guarantee the value or condition of your potential new home. If you find problems with your new home after closing, we can not give or lend you money for repairs, and we can not buy the home back from you.

That's why it's so important for you, the buyer, to get an independent home inspection. Ask a qualified home inspector to inspect your potential new home and give you the information you need to make a wise decision.

## Appraisals and Home Inspections are Different

As part of our job insuring the loan, we require that the lender conduct an FHA appraisal. An appraisal is different from a home inspection. Appraisals are for lenders; home inspections are for buyers. The lender does an appraisal for three reasons:

- to estimate the value of a house
- to make sure that the house meets FHA minimum property standards
- to make sure that the house is marketable

**Appraisals are not home inspections.**

## Why a Buyer Needs a Home Inspection

A home inspection gives the buyer more detailed information than an appraisal–information you need to make a wise decision. In a home inspection, a qualified inspector takes an in-depth, unbiased look at your potential new home to:

- evaluate the physical condition: structure, construction, and mechanical systems
- identify items that need to be repaired or replaced
- estimate the remaining useful life of the major systems, equipment, structure, and finishes

## What Goes into a Home Inspection

A home inspection gives the buyer an impartial, physical evaluation of the overall condition of the home and items that need to be repaired or replaced. The inspection gives a detailed report on the condition of the structural components, exterior, roofing, plumbing, electrical, heating, insulation and ventilation, air conditioning, and interiors.

## Be an Informed Buyer

It is your responsibility to be an informed buyer. Be sure that what you buy is satisfactory in every respect. You have the right to carefully examine your potential new home with a qualified home inspector. You may arrange to do so before signing your contract, or may do so after signing the contract as long as your contract states that the sale of the home depends on the inspection.

**I understand the importance of getting an independent home inspection. I have thought about this before I signed a contract with the seller for a home.**

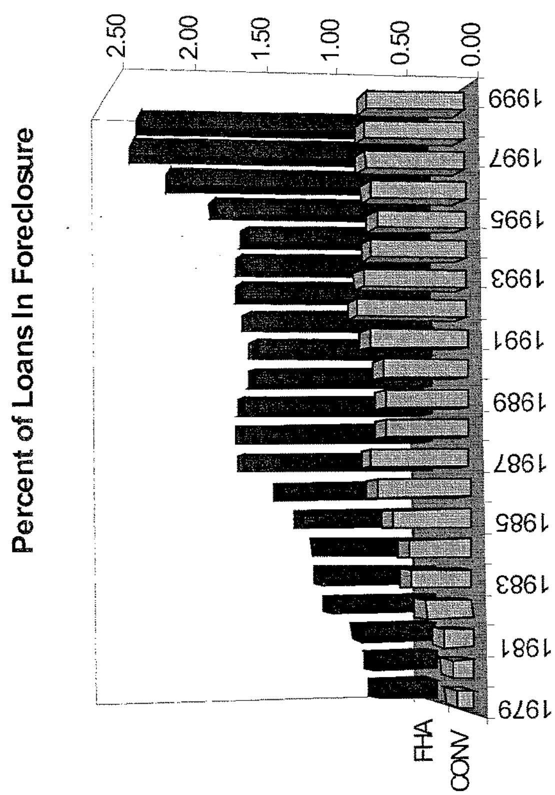
X______________________ Signature & Date

X______________________ Signature & Date

Form HUD-92564-CN
(8/99)

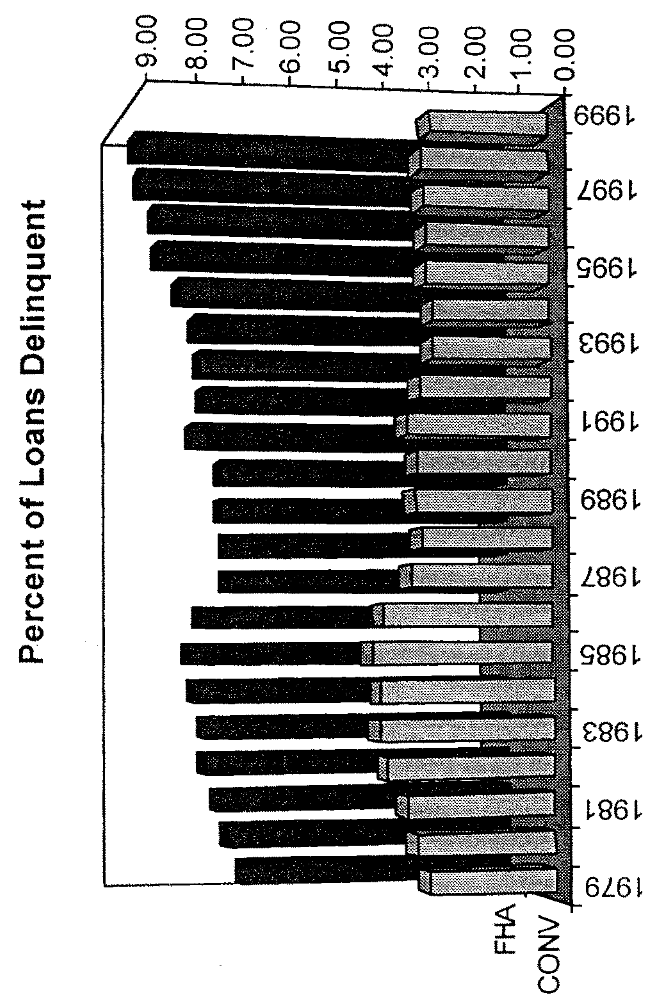
Senate Permanent Subcommittee
On Investigations

EXHIBIT # 11



Senate Permanent Subcommittee
On Investigations

EXHIBIT # 12



Senate Permanent Subcommittee
On Investigations

EXHIBIT # 13a.

June 22, 2000

**TRANSCRIPT**
**OF**
**HUD FHA Commercial**
**(June 2000 -- Currently Running On CNN and Headline News)**

*Opening scene is a man in his house nailing a plaque to his wall.*

Anouncer: Your dream home. It's all your's.

*As he hammers, the pipes in the basement break apart and water floods out of every opening of the house.*

Announcer: What a nightmare.

*Shot cuts to man drowning in the water from the pipes as his wife wakes him up.*

Man's wife: Honey, wake up. The appraiser, remember?

*Cut to man and wife meeting with appraiser outside the house.*

Announcer: With HUD's FHA Homebuyer Protection Plan, you get the right loan, a fair price, and a thorough appraisal.

*Shots include the couple looking over the house and then a shot of the appraiser's clip board as he fills out the "FHA Home Appraisal" form in front of them.*

Announcer: If any problems are found, you'll know about them before you close.

*Shot of the appraiser and then the man inspecting the pipes which he had dreamt had broken but are now perfect followed by a person stamping the appraisal form "Approved."*

Announcer: 30 million Americans have trusted us to build their dreams. Call for information on HUD homes and FHA loans. HUD and FHA- on your side.

*Shot of couple moving in and man hanging his plaque on wall once again but this time, with no problems at all.*

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Senate Permanent Subcommittee
On Investigations

EXHIBIT # 14

**MEMORANDUM**

TO: **PERMANENT SUBCOMMITTEE ON INVESTIGATIONS MEMBERSHIP LIAISONS**

FROM: **K. LEE BLALACK II**, Chief Counsel & Staff Director KLB
**RENA M. JOHNSON**, Deputy Chief Counsel RMJ
**KARINA LYNCH**, Counsel
**CLAIRE BARNARD**, Investigator
**BOB GROVES**, Investigator
**BRIAN JONES**, Investigator
**RAY KESSENICH**, Investigator
**JIM PITTRIZZI**, Investigator
Permanent Subcommittee on Investigations

RE: BACKGROUND MEMORANDUM FOR "FLIPPING" INVESTIGATION

DATE: JUNE 27, 2000

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**TABLE OF CONTENTS**

## I. Introduction

### A. What is Flipping?

PSI's investigation has exposed a national problem with "flipping,"[1] which is an incredibly complex phenomenon that involves multiple players who conspire to defraud home buyers, lenders, and – in the case of Federal Housing Administration ("FHA")-backed loans -- the federal government. Flipping involves the purchase and quick resale of homes at a huge mark-up, often with little work done to improve the properties. The result is the false illusion of a robust real estate market created through the use of phony paperwork and deceptive sales pitches. Flipping poses significant risks to low-income, first-time home buyers, and may affect the overall stability of local neighborhoods.

In a typical "flip" transaction, an investor purchases a dilapidated house in a marginal neighborhood. The investor makes cosmetic improvements to the house, such as carpeting over rotting wood floors or painting over termite damage. The investor teams up with a realtor who markets the house as a "total rehab" to a first-time, unsophisticated, low-income home buyer. The realtor persuades the buyer to rely on him completely by repeatedly assuring the buyer that he will handle all aspects of the sale on the buyer's behalf. Due to his naivete, the buyer trusts the realtor implicitly, and declines to obtain a home inspection, retain counsel, or otherwise protect himself. If the buyer questions the value of the house, the investor and realtor can point to an inflated appraisal showing that the house is worth the asking price. The realtor steers the buyer towards a lender with whom the agent and investor have previously worked. The lender arranges for the buyer to obtain a mortgage loan, sometimes through manipulation of the buyer's financial information or acceptance of phony gift letters documenting non-existent down payments. The investor and realtor also, on occasion, retain an attorney to represent the buyer at closing. Instead of protecting the buyer's interest, however, the attorney's true function is to assure the buyer of the legitimacy of the transaction, and convince him to sign all of the closing documents.

After the buyer moves into the house, he discovers that the "total rehab" is in fact a crumbling relic. The buyer is forced to make repairs and simultaneously struggle to make monthly mortgage payments on a property, the actual value of which is significantly less than the mortgage. The end result for the buyer is often default and, ultimately, loss of his home through foreclosure. The buyer is left with no house and a tarnished credit rating, while the neighborhood is left with a vacant, deteriorating house. The flippers, in contrast, reap the profit

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[1] In its consumer education materials, the Federal Trade Commission ("FTC") uses the term "loan flipping" to describe a slightly different predatory lending practice. The term "loan flipping," as it is defined by the FTC, denotes a lender's practice of encouraging a borrower to repeatedly refinance his loan, often to borrow more money. Each time the borrower refinances, he pays additional fees and interest points, which ultimately increase the borrower's debt.

from the sale of the house at an unjustifiably inflated price after having made only a modest or nominal investment.

Although the purchase and quick resale of a house at an increased price is not illegal, the above scenario illustrates how this practice can cross the line when documents are falsified to lure buyers and lenders into investing more money in a house than it is worth. Flippers who get FHA backing for their buyers' mortgages are able to encourage lenders to put up the full amount of the loan, confident that if the buyer defaults, the government will bail them out. Lenders, appraisers, and other parties who are guilty of this practice may be barred by the United States Department of Housing and Urban Development ("HUD") from participating in federally financed or insured business.

B. Overview of PSI's Investigation

PSI began this investigation with a preliminary inquiry in September 1999. Its objective was to evaluate the scope and nature of the flipping problem across the country. PSI initiated its investigation by building on the work of enforcement agencies and an investigation by Baltimore Sun reporter John O'Donnell, who is widely credited with exposing the problem of flipping in Baltimore. Since that time, PSI staff has interviewed more than one hundred witnesses and reviewed hundreds of records confirming that the phenomenon of flipping is not simply a local, state, or even regional problem, but rather is a nation wide crisis. PSI staff has spoken with myriad victims, real estate brokers, lenders, and attorneys involved in mortgage flipping cases, as well as government officials, community activists, and other stakeholders. This memorandum seeks to brief you on the results of this investigation.

II. The Players in a Flipping Transaction

A. Lenders

Lenders must obtain approval from HUD to participate in FHA's mortgage programs. In addition to an application form and fee, lenders must submit to HUD documentation showing that they meet FHA's requirements for lending experience, financial worth, and adequacy of facilities. As of December 1999, approximately 9,950 lending institutions were approved to participate in FHA's mortgage insurance programs for single-family homes. Most of these lenders are authorized only to *originate* FHA-insured loans, meaning that they can accept mortgage applications, obtain employment verifications and credit histories on applicants, order appraisals, and perform other tasks that precede the loan underwriting process. However, approximately 2,900 of the FHA-approved lending institutions have *Direct Endorsement* authority[2] in addition to loan origination authority. Such lenders can underwrite loans and determine their eligibility for FHA mortgage insurance without HUD's prior review.[3]

Prior to 1983, FHA staff reviewed and approved, or "underwrote," most loans prior to insurance endorsement. In 1983, FHA delegated to approved lenders Direct Endorsement authority. As a result, lenders with Direct Endorsement authority became responsible for virtually all aspects of the loan origination, underwriting, and closing process.[4] HUD describes Direct Endorsement as the mechanism that enables HUD/FHA-approved lenders to consider single-family mortgage applications without first submitting paperwork to HUD, thereby enabling FHA-insured mortgages to be processed as rapidly as other mortgages.[5]

The Direct Endorsement underwriting and endorsement process requires the lender to determine that a property is acceptable for mortgage insurance by completing an analysis of the property to determine its eligibility for endorsement and the maximum mortgage amount. The lender must also complete a credit analysis of the borrower to determine his or her creditworthiness. An underwriter must review the appraisal report and mortgage credit analysis, then certify or approve the loan package. The lender must execute a "mortgagee's certification" to HUD stating, "I, the undersigned, as authorized representative of ________, mortgagee, at the time of closing of this mortgage, certify that I have personally reviewed the mortgage loan documents, closing statements, application for insurance endorsement, and all accompanying documents. I hereby make all certifications required for this mortgage as set forth in HUD Handbook 4000.4."[6] The lender then submits to HUD the loan case binder. HUD completes a pre-endorsement review of the loan case binder, which concludes with endorsement of the mortgage for an acceptable submission through completion of a "Mortgage Insurance

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[2] Direct Endorsement is authorized under Section 203(b) of the National Housing Act, codified at 12 U.S.C. § 1709(b), (l). Program regulations are located at 24 C.F.R. §§ 203.5 and 203.255. The program is administered by HUD's Office of Housing-Federal Housing Administration. <u>See</u> U.S. Dep't of Hous. and Urban Dev., <u>Direct Endorsement</u> 2 (visited June 13, 2000) <http://www.hud.gov.progdesc/direct-r.html>.

[3] U.S. Gen. Accounting Office, GAO/RCED-00-112, Single Family Housing: Stronger Oversight of FHA Lenders Could Reduce HUD's Insurance Risk 7-8 (Apr. 28, 2000).

[4] Office of Inspector Gen., U.S. Dept. of Hous. And Urban Dev., Audit Report # 00-SF-121-001, Single Family Production Home Ownership Centers 1 (Mar. 30, 2000).

[5] U.S. Dep't of Hous. and Urban Dev., <u>Direct Endorsement</u> 1 (visited June 13, 2000) <http://www.hud.gov.progdesc/direct-r.html>.

[6] U.S. Dep't of Hous. and Urban Dev., Single Family Direct Endorsement Program, 4000.2, Appendix 4, Mortgagee's Certifications.

Certificate," which it issues to the lender.[7] After insurance endorsement, HUD reviews select properties and mortgage credit analyses through the post-endorsement technical review and on-site lender review processes described below. The percentage of such cases reviewed ostensibly depends upon the quality of past underwriting and servicing problems on earlier loans.[8]

Lenders have an obvious and significant financial interest in loan approval. In order to limit the risks inherent in transferring so much responsibility to lenders, FHA implemented new procedures to monitor Direct Endorsement lenders, primarily through pre-closing status reviews, pre-endorsement loan screening, post-endorsement technical review, and on-site lender monitoring.[9] A brief description of each of these evaluation tools follows:

*Pre-closing reviews:* When new lenders apply for Direct Endorsement approval, they are initially placed on "pre-closing" status, which means that HUD reviews their loan packages prior to closing to determine whether the lenders have the capacity to originate and underwrite loans properly in accordance with FHA guidelines.[10]

*Pre-endorsement loan screening:* Endorsement contractors working for HUD are required to ensure that FHA loan file documents are both accurate and complete prior to issuing Mortgage Insurance Certificates to the originating lenders.[11] The contractors basically determine that certain key loan documents are in the file prior to insurance endorsement. The contractors must also verify the accuracy of certain loan information as included in the loan file documents and as input into HUD's automated system by lenders. The contractors are required to verify that some loan documents are in every file, while other loan documents – such as gift letters – are only required under certain circumstances.[12]

*Post-endorsement technical review:* This involves reviewing a sample of cases after insurance endorsement to ensure compliance with HUD underwriting and appraisal

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[7] U.S. Dep't of Hous. and Urban Dev., Direct Endorsement 1 (visited June 13, 2000) <http://www.hud.gov.progdesc/direct-r.html>.

[8] U.S. Dep't of Hous. and Urban Dev., Handbook 4000.4 REV-1, Single Family Direct Endorsement Program, Chapter 1, Section 1-2, at 1-1, 1-3, 1-4 (Dec. 1992). This memorandum examines the adequacy with which HUD targets high-risk loans and lenders in Part V, below.

[9] Office of Inspector Gen., U.S. Dept. of Hous. and Urban Dev., Audit Report # 00-SF-121-001, Single Family Production Home Ownership Centers 1 (Mar. 30, 2000).

[10] Id. at *v*.

[11] Id.

[12] Id. at 51-52.

requirements.[13] The post-endorsement technical review process is explained in greater detail in Part V. below.

*On-site lender monitoring:* HUD's Quality Assurance Divisions perform on-site monitoring reviews, also called field reviews, of Direct Endorsement lenders to identify and correct poor origination practices.[14] Field reviews are examined more thoroughly in Part V. below.

B. Appraisers

FHA originally required appraisals to be an independent check on the value and condition of the property for which a borrower was seeking an FHA-insured mortgage. Until 1994, for each proposed mortgage, HUD selected, on a rotational basis, an appraiser from HUD's FHA "Appraiser Fee Panel" to appraise the property.[15] To be placed on this panel, HUD required appraisers to demonstrate a high level of experience and be knowledgeable about the appraisal process and property standards that homes being considered for FHA-insured mortgages must meet. HUD closely monitored Fee Panel appraisers by field reviewing at least 10% of their appraisals yearly. In addition, HUD trained Fee Panel appraisers to ensure that homes for which FHA insurance was being sought were safe, sound, and sanitary.[16] Under this system, the lender completed an "Application for Property Appraisal and Conditional Commitment," then contacted its local HUD office to receive a case number and the name of an appraiser.[17]

In December 1994, HUD implemented regulations mandated by 1990 amendments to the National Housing Act that transferred appraisal selection responsibilities from FHA staff to Direct Endorsement lenders.[18] Under this system, which is commonly known as the "Lender Select" appraisal system, HUD disbanded the Fee Panel and delegated responsibility for

[13] Id. at *iv.*

[14] Id.

[15] Prior to 1994, HUD approved appraisers were referred to as Fee Appraisers and the list of HUD approved appraisers was referred to as a Fee Appraiser Panel.

[16] Telephone interview with James Smith (June 6, 2000); telephone interviews with Frank DiGiovanni (May 17-18, 2000).

[17] U.S. Dep't of Hous. and Urban Dev., Mortgagees' Handbook, 4000.2, Chapter 2, Section 1-10, at 2-5 (July 1991).

[18] In 1988, when asked why lenders should be allowed to select their own appraisers for liability-free HUD insured mortgages, Representative Barnard (D-GA) responded, "The lender wanted to have as much control of the transaction as possible - which included the appraiser." Frank DiGiovanni, Chronological History of Appraisal in the Chicago Area, Including HUD/FHA Data, (rec'd May 23, 2000).

selecting appraisers to Direct Endorsement lenders. Such lenders are allowed to select any appraiser that was licensed by the state in which he or she practiced.[19] According to one appraiser, this delegation led to the use of the least qualified appraisers for FHA-backed mortgages.[20] In Illinois, for example, an apprentice appraiser who may have insubstantial experience is nevertheless licensed. As a result, it appears that real estate agents have influenced lenders to choose certain appraisers to evaluate their properties, thereby obtaining appraisals of sub-par properties at inflated values.[21]

One appraiser PSI staff interviewed opined that in his experience as an appraiser, it was not unusual for banks to request that the appraised value of a property be increased. He said that some of the requests he received were impossible to accommodate because the property did not justify the specified increase.[22]

Overall, the results of the Lender Select program have been less than satisfactory. A 1999 report by the General Accounting Office ("GAO") found that "HUD was not doing a good job of monitoring the performance of appraisers"[23] and "is not holding appraisers accountable for the quality of their appraisals."[24] The report concluded that "HUD has not aggressively enforced its policy to hold lenders equally accountable with the appraisers they select,"[25] and that "HUD has limited assurance that the appraisers on its roster are knowledgeable about FHA's appraisal requirements."[26] The findings of this report are set forth more fully in Part V., below.

C. Inspectors

Our research has disclosed that FHA does not presently require home buyers to obtain a home inspection as a prerequisite to obtaining an FHA-backed mortgage, nor has it ever required that they do so. Prior to 1996, FHA advised home buyers to obtain inspections in conjunction with advisories regarding interest rates, discount points, loan fraud, and lead-based paint. In

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[19] Telephone interview with Frank DiGiovanni (May 27, 2000).

[20] Id.

[21] Bill Rumbler, Shady Deals Alleged in FHA Appraisal System, Chicago Sun-Times (Sept. 28, 1997).

[22] Interview with Robert Skovera in New York City, N.Y. (June 8, 2000).

[23] U.S. Gen. Accounting Office, GAO/RCED-00-112, Single-Family Housing: Weaknesses in HUD's Oversight of the FHA Appraisal Process 2 (Apr. 16, 1999).

[24] Id.

[25] Id. at 3.

[26] Id.

December 1996, FHA announced that it would begin highlighting the need for home buyers to obtain home inspections through distribution of a separate form entitled, "Importance of Home Inspections." This form explained to the buyer the benefits of arranging for a professional inspection of the home, but also advised, "There is no requirement that you hire an inspector." FHA required the buyer to sign and date the form on or before the date of execution of the sales contract, but it did not require retention of the form in the FHA endorsement binder.

In June 1998, FHA announced as part of its Homebuyer Protection Plan the replacement of the "Importance of Home Inspections" form with a new form entitled, "For Your Protection: Get a Home Inspection." The updated form advises the home buyer that FHA does not guarantee the value or condition of the property; that an appraisal is not a home inspection; and that the borrower has the right to have the house inspected by a professional home inspector. In contrast to the previous form, the new form must be retained in the FHA insurance endorsement binder. FHA allows home buyers to finance at least a portion of the cost of the inspection through the FHA-backed mortgage that they obtain.

On May 12, 1999, Representative Rick Lazio (R-NY) introduced H.R. 1776, the American Home Ownership and Economic Opportunity Act of 2000. This bill, among other things, requires the GAO to conduct a study regarding the inspection of properties purchased with FHA-backed mortgages. The proposed study will evaluate such issues as the feasibility of requiring inspections of all properties purchased with FHA-insured loans; the monetary impact of such a requirement on the FHA insurance fund and home buyers; and the impact of mandatory inspections on the process of buying a home. This bill passed the House by a 417-8 vote on April 6, 2000, and has been referred to the Senate Committee on Banking, Housing, and Urban Affairs.

III. The Nationwide Scope of Flipping

To illustrate the truly nationwide epidemic that is flipping, we have developed case studies of various flipping schemes in cities throughout the United States. These case studies provide a glimpse of how these frauds are perpetrated as well as the financial and emotional toll that often results.

A. New York City: The Story of Lisa Smith

Lisa Smith is a New York City police officer and a single mother of three who sought to move her family out of their apartment and into a house. She has agreed to tell her story by testifying on the first day of PSI's hearings at the end of June.

Smith was a first time home buyer when she responded to an advertisement in a local newspaper by Lenders Realty, a real estate agency specializing in the sale of foreclosed properties. The former manager of Lenders described it as a speculative business that acquired houses, primarily foreclosures, for investment purposes. After purchasing the houses, Lenders would renovate and sell them.

After Smith contacted Lenders, its representatives showed her a house located at 145-08 123rd Avenue in the Queens neighborhood of South Ozone Park. Lenders representatives, whose names Smith cannot recall, told Smith that the house had been completely renovated during the two years it had been vacant. Lenders representatives also told Smith that they would assist her with everything related to the closing of the property. When Smith expressed concern about her lack of understanding of the process of purchasing a house to the Lenders representatives, all of whom were women, they told her that she could trust them because they would not deceive another woman. After Lenders representatives showed her the house, they told her that if she did not enter into a contract immediately, the house would be sold to another buyer.[27]

On May 5, 1997, Smith signed a sales contract to purchase the house for $129,000.[28] The seller, AllBorough Inc., had purchased the house in December 1996 for $50,000. Smith's sales contract contained an "as is" clause providing that Smith had inspected the property, was thoroughly acquainted with its condition, and agreed to purchase it in its present condition.[29] However, the contract also stated that the seller agreed to pay for all necessary repairs, which according to Smith did not occur.

Smith's contract and its rider also contained clauses regarding title inspections and the purchaser's right to have a termite inspection. Smith signed a form advising her of the importance of a home inspection; however, she did not check off either box indicating that she intended to have a home inspection or waive it. Smith did not obtain an inspection of the house because Lenders representatives told her that Lenders had already paid for an inspection, which had revealed that the house was in good condition.[30] This was an apparent misrepresentation. The former manager of Lenders told PSI staff that it was not part of the company's business

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[27] Telephone interview with Lisa Smith (June 15, 2000).

[28] The appraiser who valued Smith's house at this price did not specifically remember appraising her house. However, he recalled that Smith's lender, Alliance Mortgage Banking Corporation, had in the past asked him to increase the appraised value of properties, but he did not consider Alliance one of the worst offenders in using this practice. Interview with Robert Skovera in New York City, N.Y. (June 8, 2000).

[29] At least one court has noted that the days of caveat emptor in real estate are gone. See Gibb v. Citicorp Mortgage, Inc., 518 N.W.2d 910, 918-19 (Neb. 1994). PSI staff's review of case law evaluating real estate sales contracts containing "as is" provisions suggests a weakening of the protection such a clause bestows on the property seller, particularly if the sale has been predicated on fraud or misrepresentation. Furthermore, "as is" clauses are standard, boilerplate inclusions in real estate contracts for the purchase of existing houses, and it is unlikely that Smith would have been able to sign a contract that did not contain the clause. Telephone interview with Charles Dale, Congressional Research Service (May 9, 2000).

[30] Interview with Lisa Smith in New York City, N.Y. (June 8, 2000).

practice to have inspections performed, and that Lenders routinely arranged for only appraisals of properties it sold.[31] Furthermore, Robert Skovera, who appraised Smith's property at the request of her lender, told PSI staff that if Lenders had characterized his appraisal as a home inspection, that would have been a misrepresentation.[32]

As an NYPD employee, Smith is entitled to receive free legal services from the Police Benevolent Association ("PBA"). However, Lenders representatives falsely told Smith that the PBA attorney whom she had arranged to represent her had disparaged her, thereby persuading Smith to use a lawyer Lenders selected to represent her during the home buying process free of charge. The lawyer repeatedly assured Smith that he was acting in her best interest. When she tried to ask him questions about the sales contract, he told her not to worry and to sign the document.[33]

In connection with the purchase of the house, Smith signed a gift affidavit representing that Bernard Tyndall, a cousin of Smith, would provide her with $4,100 in gift money at the closing to use in the purchase of the house. In fact, Tyndall is not Smith's cousin, but rather the father of two of her children. He also did not give her any money for use in the purchase of the house.[34] Smith explained to PSI staff that a Lenders representative gave her the blank affidavit and told her that all home buyers receiving FHA insured mortgages must sign gift letters as a mere formality. Smith's attorney was present during this exchange. Smith asked him if it was permissible for her to sign it, and he assured her that it was. Additionally, one of the female Lenders representatives reassured Smith that completing the form was not illegal. Smith took the affidavit to Tyndall and asked him to complete it. He did so, but, at Lenders' direction, left the amount blank. Smith also signed the gift affidavit, then returned it to Lenders.

In retrospect, Smith wishes she had not signed the affidavit, but contends that she did so because she felt that her lawyer would not instruct her to break the law.[35] In addition, it is noteworthy that when PSI staff provided Smith with a copy of the gift affidavit, she was surprised that the affidavit did not reflect her recollection of its contents. She recalled that Lenders representatives had told her that the purported gift amount would be limited to between $500 and $1,000, not the $4,100 that is listed on the affidavit. Furthermore, she did not recognize the handwriting on the affidavit other than the signature of Tyndall, and the bank account information listed was fictitious.

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[31] Interview Howard Krin in New York City, N.Y. (June 8, 2000).

[32] Interview with Robert Skovera in New York City, N.Y. (June 8, 2000).

[33] Interview with Lisa Smith in New York City, N.Y. (Feb. 1, 2000).

[34] Telephone interview with Lisa Smith (June 12, 2000).

[35] Id.

In July 1997, Smith closed on the house. Lenders arranged for Alliance Mortgage Banking Corporation to finance Smith's mortgage.[36] No one ever explained the different types of mortgages available to her. When PSI staff first interviewed Smith, she had no idea what "FHA" meant despite having obtained an FHA-backed mortgage. Although the attorney Lenders procured for Smith attended the closing, his primary function was merely urging her to sign all of the closing documents.

Smith encountered numerous problems after moving into the house. The basement flooded constantly and raw sewage backed up into the house. Smith called Lenders several times to complain about this problem, but never received any response. When Smith gave PSI staff a tour of the house, the odor in the basement was overwhelming due to the constant problem of sewage backing up. A contractor she consulted informed her that the problem would never cease. The roof leaked, inadequate insulation resulted in $400 to $500 monthly heating bills, the siding needed replacement, and the floor was falling apart. Smith was particularly upset about the windows in the house because Lenders representatives had told her that they were brand new, but after moving into the house she discovered that they were not; in fact, she was forced to cover the windows with plastic in a vain attempt to keep cold air out of the house.[37]

Smith could not afford to make the repairs necessary to render the house habitable despite her attempts to do so by obtaining two additional loans: The first in May 1998 from The Money Store for approximately $12,000 at an interest rate of 11.49%, and the second in February 1999 from Madison Home Equities for approximately $45,000 at an interest rate of 14.21%. Ultimately, she could not afford to continue making the payments on her mortgage as well as on these additional loans. On advice from her new PBA counsel, she stopped making mortgage payments in December 1999 and, in March 2000, abandoned the house altogether. Smith has moved her family back into an apartment. As a result of her decimated financial situation, she has declared bankruptcy. Smith has also been served with a summons for defaulting on the first of her three mortgages.[38]

Lisa Smith's case highlights the elements required for successful flipping. For example, although Smith is a police officer with an associate's degree in liberal arts from LaGuardia Community College in New York, she was certainly not sophisticated enough to navigate the complex financial transaction of buying a house without bona fide guidance. Nor did she know that, as a general matter, prospective home buyers hire their own representatives to protect their interests. Her naivete rendered her vulnerable to the high pressure tactics employed by Lenders.

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[36] PSI's investigation has revealed that Lenders ceased operating in January 2000. However, Robert Skovera, who appraised Smith's house prior to her purchasing it, told PSI staff that the former owner of Lenders is also a principal at Alliance Mortgage Banking Corporation.

[37] Interview with Lisa Smith in New York City, N.Y. (Feb. 1, 2000).

[38] Interview with Lisa Smith in New York City, N.Y. (May 5, 2000).

Furthermore, Smith had recently terminated an abusive relationship with the father of her youngest child. The relationship had caused tremendous emotional duress for Smith and her children. The family was undergoing counseling and trying to put the pieces of their lives back together. Smith wanted to be able to prove to herself that she could increase the quality of life for her family; it was at this time, and under these circumstances, that she began looking for a house to purchase. Smith's confusion and her reliance on the "professionals" contributed to her victimization.

B. Chicago: The Story of Stekeena Rollins

PSI staff interviewed eight Chicago home buyers, each of whom purchased a home from either a real estate agency known as Easy Life Realty ("ELR") or Ace Realty, its successor. Richard Nelson and Louis Prus owned both businesses. Prus and Nelson began working together in the early 1970s by forming the Easy Life Real Estate and Management System, Inc. ("ELR"), with the intention of managing and selling properties owned by others. In the 1980s, they began to acquire, renovate, and sell houses that needed only cosmetic repairs. In the 1990s, they began to acquire distressed properties that needed much more rehabilitation, such as replacement of mechanical systems, before they could be sold. Nelson and Prus referred to this as their "REO," or Real Estate Owned, program. At its peak, ELR employed a sales force numbering between forty and fifty salespersons.

ELR acquired properties through its sales force. A salesperson would locate and purchase a dilapidated property on ELR's behalf using funds approved by Nelson. Prus and Nelson claim that the salesperson handled everything from planning and implementing the rehabilitation work to marketing and selling the property. ELR's role was to finance the venture. Upon the sale of the property, the salesperson earned a large percentage of the profit for his efforts, usually 40%. Such an arrangement would provide the salesperson with an incentive to minimize rehabilitation costs and, if necessary, to funnel down payment money to prospective purchasers who would otherwise not qualify for a mortgage, although Nelson and Prus profess ignorance regarding this practice. ELR did not obtain building permits for the rehabilitation work it conducted on the properties PSI examined. As a result, the City of Chicago conducted no inspections to ensure that the rehabilitation work was done properly.

In 1996, HUD threatened to bar Nelson and ELR from participating in FHA programs based on allegations that ELR had provided funds to purchasers to use as down payments and falsified documentation. Nelson and ELR entered into a settlement agreement with HUD pursuant to which Nelson paid a $35,000 penalty. In exchange, HUD agreed to permit ELR to continue participating in FHA programs.

A number of the home buyers with whom PSI staff spoke are named plaintiffs in a pending federal class action against Nelson, Prus, ELR, and Ace. This civil lawsuit, which was filed in August 1997, alleges violations of the Racketeer Influenced and Corrupt Organizations Act, the Fair Housing Act, and the Civil Rights Act, as well as violations of state fraud and consumer protection statutes. The complaint avers that the defendants committed these violations by systematically defrauding residents of the overwhelmingly minority Austin community in Chicago for the last decade by running false and misleading real estate advertising; misrepresenting the condition of the properties that they sold; exerting total control over plaintiffs' financing for their purchases; discouraging or preventing plaintiffs from obtaining independent attorneys, inspectors or other safeguards in the home purchase process; engaging in inflated pricing; performing or controlling dangerously shabby construction work; and committing outright bank fraud. The number of plaintiffs who have joined the class is 105. The hotly contested action is presently in the discovery phase.

Nelson and Prus each asserted their Fifth Amendment privilege against self-incrimination in response to PSI subpoenas compelling their appearances at depositions.

Stekeena Rollins purchased a 95-year old home located at 130 North Latrobe Street in Chicago along with her mother, Shirley Rollins. Stekeena is a high school graduate who completed some course work at a community college in Chicago. Since graduating from high school, she has worked as a bank teller, in child care, and as a nursing home assistant. Stekeena was a 20 year old single mother when she purchased the house. Like Stekeena, Shirley was also a first time home buyer. Although she had attended two years of high school, she did not graduate. Instead, she completed two years of trade school, and three months of college studying food service. She was 49 years old at the time of she bought the house, and had custody of five grandchildren. Her employment history includes jobs at child care facilities, factories and schools. She has been unemployed since 1998.

Stekeena has agreed to testify at our hearing on June 29. She is expected to testify that the Rollinses first became aware of ELR in June 1995, when they saw one of its advertisements in the *Chicago Sun-Times* proclaiming, "Kiss Your Landlord Goodbye!" After seeing the advertisement, they visited ELR's office where they met Peter Sandow, a real estate salesperson. The Rollinses told Sandow that they wanted to purchase a house large enough to allow Stekeena to operate a day care center from their home. Sandow showed them several homes in the Austin neighborhood of Chicago, but the Rollinses specifically told him that they did not want to live in Austin because of their concerns about violence and drug activity. Sandow then showed them a house that he said was in Oak Park, an upper-middle class neighborhood adjacent to Austin. The house, which had been converted into two separate flats, had been damaged in a fire, was leaning to one side, and obviously needed a lot of work. However, it was large enough to fit their objective of operating a day care center, and Sandow assured the Rollinses that pursuant to an unspecified federal program, ELR would thoroughly rehabilitate the house, pay for an inspection, and provide a lawyer to represent them at closing. The Rollinses accepted and relied on these assurances in deciding to purchase the house. Accordingly, on July 21, 1995, the Rollinses signed a contract for the purchase of the house for $119,000, after paying $500 as an earnest money deposit.[39]

The purchase contract Stekeena and her mother signed in July 1995 did not include any provisions relating to home inspections. However, around the time they signed that contract, they also signed a HUD form encouraging them to obtain a home inspection, as well as an Illinois Association of Realtors form advising them of their right to request a home inspection. Stekeena stated both to PSI staff and during her deposition in the pending civil action that, prior to closing, she asked Sandow whether she needed to do anything to finalize the sale of the house. Sandow told her that ELR would supply a lawyer to represent her at closing, an inspection of the home, and an examination of the home by a termite control company. Stekeena relied on his representation that ELR would follow through on these promises, and did not question whether ELR had actually accomplished any of them prior to closing.

In August, the Rollinses discovered through a family friend that the house was actually located in the Austin neighborhood, not in Oak Park. When Shirley confronted Sandow with this discovery, he replied that they could not renege on their agreement to purchase the house because they were "locked in" as a result of signing the sales contract. He also told her that, if she tried to get out of the sale, she would never get another FHA-backed mortgage.[40]

Just prior to closing, Sandow explained that because the Rollinses were first-time home buyers, the federal government would provide them with $6,000 to use as a down payment. To take advantage of this program, Sandow told the Rollinses to enlist the assistance of someone with a bank account whom they could trust. The Rollinses secured the aid of 24-year old Valencia Lockhart, a family friend. Sandow accompanied Lockhart to the bank, where he gave her $6,000 in cash. At Sandow's direction, Lockhart deposited the cash into her account, then immediately purchased a cashier's check for $6,000 made payable to Stekeena. After the completion of this transaction, Sandow paid Lockhart $50 in cash for her assistance.[41] Lockhart then executed a phony gift affidavit documenting her alleged gift to the Rollinses. Although the Rollinses' signatures appear on this affidavit, they do not remember signing the affidavit, and the signatures do not match their signatures on the sales contract or closing documents.

The Rollinses closed on the house on September 29, 1995. At the closing, the Rollinses saw an appraisal valuing their house at $119,000, a termite inspection certificate indicating that there was no visible termite damage, and the results of a roof inspection indicating that the roof was in good condition. The appraisal was conducted by James Koechle, whom a federal grand

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[39] Interview with Shirley and Stekeena Rollins in Chicago, Ill. (March 28, 2000).

[40] Deposition of Shirley Rollins, at 79:13 (Dec. 3, 1999).

[41] Telephone interview with Valencia Lockhart (June 1, 2000).

jury in the Northern District of Illinois indicted on January 26, 2000 for submitting inflated appraisals to mortgage lenders in a separate non-FHA flipping scheme.

Documents the Rollinses signed at the closing include a HUD-1 Settlement Statement reflecting a down payment that included the "gift" from Lockhart. Richard Nelson, co-owner of ELR and owner of the house, signed through his attorney a form called the Addendum to the HUD- 1 Settlement Statement. This form certified that Nelson had not paid or reimbursed the Rollinses for any part of the down payment for the purchase of the house, despite the fact that ELR, through Sandow, had provided $6,000 to the Rollinses through the sham transaction with Lockhart. The Rollinses also signed this form, thereby falsely verifying that they had not received any cash from the seller for any portion of the down payment. In addition, the Rollinses signed a form indicating that they understood that they were purchasing the house "as is."

Although the Rollinses' signatures on the Addendum indicate some level of complicity in the very fraud that victimized them, Stekeena maintains that she relied completely on assurances by Sandow that she was not doing anything inappropriate, that "everybody does it" in this manner, and that this was the way the system worked. In addition, the lawyer ELR provided to represent the Rollinses at closing simply advised them to sign each document placed before them with little explanation regarding the substance of what they were signing.[42] During her deposition in the civil action, Shirley testified that, at the closing, she noted about five documents with signatures purporting to be hers which she had not signed. When she pointed this out to the lawyer, he responded that she had probably forgotten about it. Then he said something to the effect of, "Anyway, I have a boat to catch," and kept passing papers to her.[43]

Stekeena and her mother obtained an FHA-backed mortgage from a HUD approved Direct Endorsement ("DE") lender[44] called Dependable Mortgage, Inc. In a letter dated August 1996, HUD notified the president of Dependable Mortgage that the company's rate of early payment defaults and claims on FHA insured mortgages was in excess of 200% of the normal rate. Specifically, with regard to loans endorsed in 1995, as of June 30, 1996, Dependable's overall FHA mortgage default rate was 11.49%, while the FHA default rate for lenders under the jurisdiction of the Chicago HUD office was 2.15%, and the national FHA default rate was 2.66%.[45] For this reason, HUD advised that it intended to terminate Dependable's authority to originate FHA mortgages within 60 days. According to HUD staff, after HUD threatened to

[42] Interview with Stekeena and Shirley Rollins in Chicago, Ill. (Mar. 28, 2000).

[43] Deposition of Shirley Rollins, at 70:14 (Dec. 3 1999).

[44] A Direct Endorsement lender has the authority to underwrite mortgages for FHA insurance purposes without FHA approval prior to closing.

[45] Letter from Emelda Johnson, Deputy Assistant Secretary for Single Family Housing, U.S. Dep't of Hous. and Urban Dev., to President, Dependable Mortgage, Inc. (Aug. 9, 1996).

impose these sanctions, Dependable apparently surrendered its Direct Endorsement authority voluntarily in June 1997, sold its loan portfolio, and ceased to operate.[46]

Interestingly, Deborah Tanke, who was president of Dependable at the time the Rollinses' purchased their house, notarized the false gift affidavit documenting the alleged gift from Lockhart. Tanke claims to have no independent recollection of having done this, and could only surmise that she assisted in the Rollinses' closing because Dependable was shorthanded at the time.[47]

The FHA credit analysis worksheet is used to examine an applicant's personal and financial status, monthly shelter expense, funds required for closing expenses, effective monthly income and debts and obligations. As a general rule, the applicant's prospective housing expenses should not exceed 29% of her gross effective monthly income. An analysis of the Rollinses' mortgage application indicated that the prospective housing expenses equaled exactly 29% of their gross monthly income. However, according to Stekeena, the amount listed as their monthly income has been over stated by approximately $600 per month, which is characterized as "rental income." Stekeena was unaware that this false income amount had been included on her loan application, which she did not read before signing because "it was just another form." Under the FHA guidelines, the Rollinses should not have received the loan without that additional income.

After the Rollinses had signed all the papers at the closing, Sandow told them that house sitters were staying at the house and instructed them to go to the house, ask the house sitters for the keys, and request that they leave.[48] When the Rollinses arrived at the house, they observed drug paraphernalia scattered around the house. The house sitters refused to leave, and a two-hour argument ensued. To this date, almost five years later, strangers visit the house seeking to purchase drugs from the former house sitters.[49]

The Rollinses had visited the house three separate times before closing, but ELR representatives had never allowed them to see the entire house due to what they characterized as ongoing construction. When the Rollinses moved into the house after closing, they observed termites swarming on the front and back porches, inside the house, and in the garage. A subsequent telephone call to the company that conducted the termite inspection proved fruitless; a representative simply advised them that ELR often painted over possible termite infestation,

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[46] Telephone interview with Janice Ligon, Office of Lender Approval and Recertification, U.S. Dep't of Hous. and Urban Dev. (May 7, 2000).

[47] Deposition of Deborah Tanke, at 120:1-5 (March 8, 2000).

[48] Interview with Stekeena and Shirley Rollins in Chicago, Ill. (Mar. 28, 2000).

[49] Id.

thereby precluding its detection. The termite damage was so severe that Stekeena fell on the front porch and severely hurt her leg.[50]

The Rollinses soon began discovering other problems with the house. Contrary to Sandow's representations, the house was not suitable for a day care center because it did not meet city standards, and Stekeena's business application was denied.[51] A substandard furnace in the basement caused leaks.[52] A gas company representative told them that the pipes used on the furnaces were old, were not originally designed to be gas pipes, and appeared to be connected in a slipshod fashion.[53] A gap developed between the wall and the floor in the living room where snow and rodents entered the house. Other problems with the house included water leaks, sewage backups in bathrooms, and faulty electrical wiring.[54] An attorney who is attempting to renegotiate their mortgage told them that the house had been illegally converted into a two flat structure.[55]

The Rollinses complained numerous times to ELR about the condition of their house. In the beginning, ELR sent workmen to the house on roughly five occasions. The workmen repaired water damage to the first floor bedroom and dining room ceilings, and damage resulting from pipes that froze due to lack of insulation. They also painted the front porch to cover boards that were damaged by rot, replaced the first and second floor carpets that had suffered water damage, and stabilized the back stairs that were falling apart.[56] Eventually, however, ELR stopped responding to their complaints.

After the Rollinses contacted the FBI about ELR in January 1996, Sandow contacted the Rollinses in April to offer them season tickets to the Chicago Bulls games and to treat them to dinner if they stopped complaining. The Rollinses rejected these offers. Louis Prus, one of the

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[50] Deposition of Stekeena Rollins, at 35:3-6 (Dec. 8, 1999).

[51] Interview with Stekeena and Shirley Rollins in Chicago, Ill. (Mar.28, 2000).

[52] Id.

[53] In December 1997, the Chicago Community Economic Development Association repaired and retrofitted the Rollinses' furnace pilot light system, insulated the attic, installed a smoke detector, and repaired doors. These efforts cost almost $2,500.

[54] Interview with Stekeena and Shirley Rollins in Chicago, Ill. (Mar. 28, 2000).

[55] Telephone interview with Stekeena Rollins (May 1, 2000).

[56] Id.

owners of ELR, then stopped by to look at the house with his wife, but nothing resulted from his visit.[57]

By October 1999, the Rollinses were about two to three months behind in their mortgage payments. The Rollinses have not made payments since that time because of a HUD moratorium on foreclosures of properties ELR sold, and because of efforts by their attorney to renegotiate the terms of their mortgage.[58]

An inspection of the house in November 1999 supports the conclusion that any repairs ELR made to the house contributed to its deterioration instead of enhancing its value. Specifically, the inspection noted severe problems with the roof, structure, foundation, exterior, electrical system, plumbing, heating system, basement, stairs, and chimney. The inspection determined that the basement bedroom is completely inhabitable due to lack of ventilation. The inspection thus noted major deficiencies in the house that were either created or obscured by ELR's rehabilitative efforts, and identified obvious repairs that should have been made but were not.

C. South Florida: The Story of Sonia and Carlos Pratts

Sonia Pratts and her husband Carlos purchased their home at 6121 Jackson Street in Hollywood, Florida, from New Southwest Properties, Inc. ("NSP") for $80,000 on February 20, 1998. NSP had purchased the property on September 2, 1997 from HUD for $44,600. Sonia has agreed to testify at our hearing on June 29.

Sonia received an associate's degree in liberal arts from Boricua College in Brooklyn, New York. She has also taken pharmacy courses through ICS International Correspondence School, phlebotomy courses at Froward Community College, and counseling courses at Florida Bible College. Sonia formerly worked as a "ward clerk" and "certified nurse." In this capacity, she cared for premature, HIV-positive, and drug addicted infants by performing such tasks as maintaining a sterile environment, monitoring medication and supplies inventory, bathing and weighing the infants, and preparing discharge and transfer paperwork. As a result of a back injury she suffered during the course of her employment, Sonia now works as an assistant manager at a senior citizens center. Sonia was eliminated from their loan application for the house because she had filed for bankruptcy nearly ten years earlier after her ex-husband abandoned her and their three children. Her gross monthly income at the time that she and Carlos purchased the house was roughly $1,200.

Carlos has a sixth-grade education. He was working as a driver/warehouse worker at Little Guys Food Service at the time he applied for their mortgage. In addition to his gross

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57 Deposition of Stekeena Rollins, at 128:12-17 (Dec. 8, 1999).

58 Telephone interview with Stekeena Rollins (May 1, 2000).

monthly salary of approximately $1,700, he was also receiving Supplemental Security Income of $521 per month because he had been diagnosed as schizophrenic. He is presently unemployed.[59]

The Prattses had been saving to purchase a residence for several years. In October 1997, as they were driving through various neighborhoods looking at houses, they saw a sign posted in front of a house offered for sale by ERA Homeland Realty Corporation. The Prattses called the number on the sign and subsequently met with two real estate persons, P. Alias Thomas and ViJayan V. Thomas. The Thomases steered the Prattses away from the house that had initially attracted their attention to the house on Jackson Street that they ultimately purchased. They then introduced the Prattses to Joe Kuruvila who, in addition to owning ERA Homeland Realty, also owned NSP, in whose name the Jackson Street property was titled.[60]

The Prattses told Kuruvila that they wanted a property that needed no repairs because they were using their entire savings for the down payment, and accordingly would have no funds for renovations. When Kuruvila showed them the house on Jackson Street, the Prattses realized it was in the process being repaired. In response to their inquires, Kuruvila assured them that the property had no structural problems and no code violations. At one point Carlos drove by the house and noticed a code violation taped to the door.[61] City of Hollywood records indicate that a notice of code violations was posted on the Jackson Street property in October 1997. These code violations consisted of failing to obtain the requisite building permits for an addition to the property and for replacement of a window. The city mailed NSP a letter via certified mail, return receipt requested, in November 1997, notifying it of the code violations. The city again posted a noticed of the code violations on the property in January 1998. When Carlos confronted Kuruvila about the code violations, Kuruvila reassured him that all repairs would be completed, and that the code violations would be remedied.[62]

On December 20, 1997, the Prattses signed a contract for the purchase of the Jackson Street residence. This contract included a rider that has become the subject of much controversy. The rider disclosed to the Prattses that NSP and ERA Homeland Realty were 100% shareholders of their mortgage lender, Hollywood Mortgage Corporation. Thus, Joe Kuruvila owned not only the Prattses' lender, but also the seller and the real estate agency. A third entity listed on the rider as owning Hollywood Mortgage, Northeastern Properties, Inc., is also owned by Joe Kuruvila. The Prattses told PSI staff that when they signed the rider, they did not realize the

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[59] Telephone interview with Sonia Pratts (June 16, 2000).

[60] Interview with Carlos and Sonia Pratts in Hollywood, Fla. (Apr. 16, 2000).

[61] Id.

[62] Id.

relationship among the listed companies or the significance of Kuruvila's common ownership of them.[63]

The rider also provides as follows, "It is expressly understood that the property is sold 'as is', [sic] without any warranty to the purchaser, either express or implied" as to the property's zoning, its condition, freedom from defects, or fitness for any particular use or purposes. The Prattses contend that neither Kuruvila nor the Thomases explained this clause to them, and that they attached no particular significance to it when they signed the rider.[64]

Shortly after he signed the sales contract, Carlos signed a HUD form entitled, "Importance of Home Inspection." This form advised that FHA does not warrant the value or condition of a home, and encouraged the buyer to obtain an independent home inspection. Carlos indicated on the form that he chose not to have a home inspection performed. As with the "as is" clause, the Prattses attached no substantive significance to their waiver of a home inspection, particularly in light of Kuruvila's repeated assurances regarding the rehabilitation work that he was performing on the house.[65]

At the closing on February 20, 1998, the Prattses received virtually no explanation regarding the documents that they were signing. They simply signed everything put in front of them because they trusted Kuruvila. The source of the $3,900 they paid as a down payment and in closing costs was their personal savings, which they had been accumulating over a two to three year period.

The Prattses financed the balance of the purchase price through a thirty-year mortgage in the principal amount of $79,959. Carlos executed an "escrow buy down agreement" which provides that in exchange for payments of $962.70 each from NSP and Hollywood Mortgage, the Prattses' interest rate would be 5.75% for the first year of the mortgage term, with a corresponding payment of principal and interest of $572.84 per month. For the second year of the mortgage term, the interest rate would be 6.75%, with a corresponding payment principal and interest of $518.61 per month. For the remainder of the mortgage term, the interest rate would be 7.75%, with a corresponding payment of principal and interest of $572.84. This worksheet, as well as a clause in their sales contract notified the Prattses that they were obtaining a variable rate mortgage. Sonia admits that she knew that they were obtaining a variable rate mortgage, but she did not believe that the rates would increase, thereby reflecting a genuine miscomprehension regarding the terms of their mortgage.

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63 Id.

64 Telephone interview with Sonia Pratts (Apr. 24, 2000).

65 Id.

The annual taxes for the property at the time of the sale were listed at $1,187. The monthly payment of these taxes, plus monthly premiums for FHA mortgage insurance and fire insurance, increased their total monthly payments for the first year of the mortgage to $669.20. After the first two years of their mortgage term, their total monthly payments were scheduled to rise to $796.00 per month, as Carlos acknowledged in a document entitled, "Acknowledgment of Estimate of Total Monthly Mortgage Payment." At present, the Prattses are struggling to meet their monthly mortgage payment.[66]

The Prattses have experienced serious problems with the house despite the fact that Kuruvila told them that it had been completely rehabilitated. The roof, which Kuruvila told them was new, is rotting, collapsing, and leaking in several places. As a result, the ceilings have begun to crack and fall. When PSI staff members visited the house, they noted apparent water damage to the ceilings in a bedroom and back room of the residence. PSI staff verified that the house has suffered rodent infestation as well as significant termite damage. The living room has a hole in the ceiling through which Sonia claims rat droppings enter the room. The addition on the rear of the house has substantial water damage and is built on top of the septic tank, which is a city of Hollywood Construction Code and Health Department Violation. The roof fascia is rotted and has many gaps through with rats and birds have gained entrance. The wiring does not appear to be adequate and several outlets are not working. The Prattses have spent over $2,500 of their own money for various repairs thus far with no end in sight: An independent engineer whom they hired to evaluate the house advised them that they would need to spend between $40,000 and $50,000 to bring the house into compliance with the city building code, and that they would have to raze part of the house altogether.[67]

After the Prattses moved into their home, they received a letter from the City of Hollywood informing them of the outstanding building code violations on the property. The violations occurred long before either Kuruvila or the Prattses owned the house but the Prattses, as current owners, were responsible for resolving them.[68]

When the Prattses questioned Kuruvila about the outstanding fines for the code violations, he assured the Prattses that he would pay them, but to date he has failed to do so. The Prattses have filed a civil complaint in state court against Kuruvila in an attempt to resolve this matter. In addition, the State of Florida Department of Business and Professional Regulation, Division of Real Estate, has filed an administrative complaint against Kuruvila in his status as a

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[66] Id.

[67] Telephone interview with Jim Ward (Apr. 18, 2000); interview with Carlos and Sonia Pratts, in Hollywood, Fla. (Apr. 16, 2000).

[68] Telephone interview with Everett Lawson (June 19, 2000); interview with Carlos and Sonia Pratts, in Hollywood, Fla. (Apr. 16, 2000).

real estate broker, and against his companies, NSP and Homeland ERA Realty, alleging fraud in conveying the property to the Prattses.

D. Southern California

Southern California is a hotbed of FHA loan fraud. According to recent reports, the foreclosure rate on FHA-backed mortgages in Southern California is 50% higher than the national average.[69]

PSI staff attended a HUD forum in Los Angeles on May 3, 2000. This conference featured members of the Joint Task Force,[70] case studies on predatory lending, local and national industry participants, and a consumer panel that included AARP, Bet Tzedek Legal Services, the Consumers Union, the Southern California Consumer Law Center, and Neighborhood Housing Services of Los Angeles.

The focus of this conference was the effect of predatory lending on elderly communities. During the conference, PSI staff discussed the problem of flipping with various stakeholders. One individual whose insights were particularly helpful was Manuel Duran, who is a consultant for the Southern California Consumer Law Center. At Mr. Duran's invitation, PSI staff attended the monthly meeting of the Los Angeles Housing Task Force. This group, which includes representatives from HUD OIG, the Los Angeles Police Department, the California State Bar, the

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[69] See David Rosenzweig, Thirty-Nine Charged in Crackdown on Fraud in FHA-Backed Loans, Los Angeles Times, Dec. 16, 1999, <http://www.latimes.com/news/state/199912/16t000114613.html>.

[70] In April 2000, HUD joined forces with the Department of Treasury to form a Joint Task Force on Predatory Lending. The Joint Task Force consists of representatives of consumer, civil rights, community, and industry groups, as well as state and local government officials. PSI staff attended HUD's first meeting of the Joint Task Force formed by HUD and the Department of the Treasury in Atlanta, Georgia, on April 26, 2000. This was the first of five regional forums held nationwide to address predatory lending, including flipping. In addition to the Atlanta forum, PSI staff attended forums in Los Angeles and Baltimore in connection with witness interviews. The remaining two forums were held in Chicago and New York. The Joint Task Force's goal is to present Congress with two reports in June. The first report, which was released last week, summarized the findings from each of the five hearings, while the second report, which is scheduled to be released on Wednesday, June 28, will present the Joint Task Force's recommendations to Congress.

Each forum featured case studies of predatory lending victims and a panel discussion on local issues where grass roots groups discussed how predatory lending schemes affected their neighborhoods. The conferences also featured consumer groups and industry groups, with participants such as the Mortgage Bankers Association ("MBA"), and the National Home Equity Mortgage Association ("NHEMA"), which represents the sub-prime lending industry. Atlanta was chosen for the first predatory lending conference due to the prevalence of predatory lending in Georgia. This conference focused on racial disparities and the fact that minorities are often the victims of predatory lending.

Southern California Consumer Law Center, and the Los Angeles Sheriff's Department, was created to combat mortgage fraud in the state of California.

The task force discussed how Los Angeles has been successfully targeting mortgage fraud through training and consumer awareness. Local and federal law enforcement have been reluctant to prosecute flipping and other types of mortgage fraud cases because they are highly technical and difficult to prove. Many local district attorneys told PSI staff that they required training in order to acquire a level of understanding necessary to prosecute these cases, much like Medicare fraud cases in the late 1980s. In response to this need for training, Mr. Duran successfully lobbied for the passage of a bill through the state legislature that imposes a $2 surcharge on each property deed filed in the state. The funds this surcharge generates are used to train law enforcement to investigate and prosecute mortgage fraud cases. Mr. Duran and members of the task force reiterated their belief that the answer to combating mortgage fraud lies in training law enforcement to prosecute the bad actors. When questioned by PSI staff about the value in pre-purchase counseling for homeowners, they responded that counseling, while helpful in theory, is not an effective deterrent in practice.

Nicholas Aquino, Supervising Investigator, heads the Real Estate Fraud Section of the Los Angeles County Department of Consumer Affairs, which is responsible for addressing real estate fraud complaints. Southern California has seen a large influx of mortgage fraud cases that have been perpetrated through the use of stolen identities. Investigating and prosecuting flipping, particularly when victims' misappropriated identities are used for straw purchases, is complicated because victims may not know that they have been victimized until long after the "flip" occurs. In the meantime, evidence becomes stale, and witnesses forget key details about the transactions at issue.

Aquino sees flipping as a "huge" problem in Los Angeles County. In one scheme that is currently under investigation, perpetrators placed advertisements in local newspapers and canvassed neighborhoods offering low-income, first-time home buyers the opportunity to purchase a house. The individuals who responded to the offer completed a mortgage application, only to be told that they did not qualify for a loan. The perpetrators then used the victims' identification data on the mortgage application to purchase houses, which they then resold at inflated prices.[71]

The Los Angeles and Englewood Police Departments, as well as the FBI, are currently investigating a case where somewhere between 50 and 150 individuals allowed their identities to be used to purchase FHA insured "fixer uppers." These "straw buyers" were paid between $3,000 and $5,000 for the use of their identities. Moreover, in some cases, the perpetrators used these buyers' identities to purchase more than one house, unbeknownst to the straw buyers.

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[71] Telephone interviews of Nicholas V. Aquino, Supervising Investigator, Real Estate Fraud Section, Los Angeles County Department of Consumer Affairs, (February 2 and June 14, 2000).

In December 1999, a federal grand jury charged 39 persons with obtaining more than $110 million worth of fraudulent FHA insured loans through the execution of multiple fraudulent schemes through Allstate Mortgage Company.[72] Allstate set up straw companies to enter into purchase agreements to acquire apartment buildings, typically worth $100,000 to $180,000. It then hired its own appraisers who inflated the value of the buildings, usually from $100,000 to $150,000 greater than the actual market value of the properties. It also instructed appraisers to certify that properties contained four residential units even though many had more than four units. Allstate knew that under the single family insurance program HUD insured only mortgages on properties with four or fewer units. Allstate then recruited low-income individuals to serve as straw buyers and apply for FHA mortgages that were inflated by as much as $150,000 more than the actual property values. At the time the FHA-insured loans were funded, Allstate simultaneously closed on its original purchase of the properties for the actual price, pocketed the difference between its actual purchase price and the insured loan proceeds, and then sold the fraudulent loans to legitimate mortgage companies.[73]

The charges stemmed from a concentrated probe by teams of HUD OIG auditors, FBI agents, and IRS agents in Southern California. At a news conference announcing the indictment, HUD Inspector General Susan Gaffney opined that the charges were only "the tip of the iceberg." The United States Attorney for the Central District of California noted that this type of fraud "takes money from needy parents who dream of providing a house for their children and puts it into the pockets of people who have been licensed as professionals, but who really are just greedy criminals."[74]

IV. The Federal Housing Authority

The Housing Act of 1934 established FHA in order to broaden home ownership, protect lending institutions, and stimulate the building industry. By insuring lenders against loss on home loans, FHA contributed to the institution of the 30-year mortgage as a standard mortgage product. When HUD was created in 1965, FHA became an agency of HUD. All FHA programs

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[72] See David Rosenzweig, Thirty-Nine Charged in Crackdown on Fraud in FHA-Backed Loans, Los Angeles Times, Dec. 16, 1999, <**http://www.latimes.com/news/state/199912/**16t0001114613.html>.

[73] Office of Inspector Gen., U.S. Dep't of Hous. and Urban Dev., Audit Memo. # 00-SF-121-0802, Internal Audit – Single Family Housing: Los Angeles Area Office and Santa Ana Home ownership Center 4 (Apr. 6, 2000).

[74] See David Rosenzweig, Thirty-Nine Charged in Crackdown on Fraud in FHA-Backed Loans, Los Angeles Times, Dec. 16, 1999, <**http://www.latimes.com/news/state/199912/**16t0001114613.html>.

are administered through the HUD Office of Housing.[75] Since its inception in 1934, FHA has insured nearly 27.9 million loans.[76]

HUD Assistant Secretary for Housing-Federal Housing Commissioner William Apgar directs FHA. He reports directly to HUD Secretary Andrew Cuomo. FHA is organized into four major mortgage insurance fund activities. The largest activity is the Mutual Mortgage Insurance Fund ("MMIF"), which provides single family insurance. Assistant Secretary Apgar is also responsible for administering significant non-FHA programs, such as the Section 8 Rental Assistance, Section 202 Supportive Housing for the Elderly, and Section 811 Supportive Housing for Persons with Disabilities programs.[77]

A. Description of the Single Family Insured Programs

*Eligible Loan Purposes:* FHA-insured loans may be used to purchase single-family detached homes, town homes, row houses, two-to-four family buildings, manufactured homes and lots, and condominiums in developments approved by FHA. Loans may also be used to build a home; to repair, alter, or improve a home; to refinance an existing home loan; to purchase and improve a home simultaneously; or to install a solar heating and cooling system or other weatherization improvements.[78]

*Borrower Eligibility:* FHA-insured loans are available to owner-occupants who can demonstrate the ability to repay the loans according to the terms of the contract. Parties who are in default on previously FHA-insured loans may not be eligible for new loans unless the default is cleared or the borrower can show that the default was caused by circumstances beyond his control. Likewise, persons who have previously defaulted on non-FHA insured loans may not be eligible for FHA-insured loans.[79]

*Maximum Mortgage:* Mortgage limits for FHA-insured loans are set on an area-by-area basis. The limits are indexed to the lesser of two benchmarks: (1) The median home price for the area, or (2) the size of loans that may be purchased by the Federal Home Loan Mortgage

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[75] U.S. Dept. of Hous. and Urban Dev., About Housing (visited June 19, 2000) <http://www.hud.gov/fha/fhaabout.html>.

[76] Bruce E. Foote, Hous. Analyst, Domestic Soc. Policy Div., Congressional Research Serv., Order Code RS20530, FHA Loan Insurance Program: An Overview 1 (Mar. 30, 2000).

[77] Office of Inspector Gen., U.S. Dep't of Hous. and Urban Dev., Audit Report # 00-FO-131-0002, Federal Housing Administration Audit of Fiscal Year 1999 Financial Statements *i* (Feb. 29, 2000).

[78] Bruce E. Foote, Hous. Analyst, Domestic Soc. Policy Div., Congressional Research Serv., Order Code RS20530, FHA Loan Insurance Program: An Overview 4 (Mar. 30, 2000).

[79] Id. at 2.

Corporation, commonly known as Freddie Mac. The maximum mortgage limits for FHA-insured loans are 87% of the Freddie Mac limits. Since the Freddie Mac loan limits may change on January 1 of each year, the FHA mortgage limits may also change annually. Since January 1, 2000, the mortgage limits for FHA-insured loans have been \$219,849 for one-family properties, \$281,358 for two-family properties, \$340,083 for three-family properties, and \$422,646 for four-family properties. Mortgage limits for loans in Alaska, Guam, Hawaii, and the Virgin Islands may be adjusted up to 150% higher. Freddie Mac limits determine the upper and lower FHA limits while the median home price may determine the actual FHA limit for a given area.[80]

*Loan Term:* FHA-insured loans may be obtained for mortgages with terms of up to thirty years. In special cases, low-income borrowers may be eligible for 35-year loans to make the mortgage more affordable.[81]

*Down payment:* In general, the down payment is 3% of the first \$25,000 of the property value, 5% of the value between \$25,000 and \$125,000, and 10% of the value in excess of \$125,000.[82]

*Owner Occupancy:* Generally, for loans closed on or after December 15, 1989, the borrowers must intend to occupy the property as a principal residence. FHA may sell property that it has acquired as a result of default or foreclosure to either owner-occupants or investors. In some cases, those borrowers may obtain FHA-insured loans.[83]

*Program Funding:* The FHA home mortgage insurance program is funded by the Mutual Mortgage Insurance Fund ("MMIF"), which in turn is funded by the payment of FHA mortgage insurance premiums, interest earnings, and proceeds from the sale of homes that have been acquired through foreclosure on FHA-insured loans. The MMIF is authorized to fund all operations of the mortgage insurance program, including administrative costs.[84]

*Interest Rates:* The interest rate on FHA-insured loans is negotiated by the borrower, seller, and lender. The borrower has the option of selecting a loan with an interest rate that is fixed for the life of the loan or one on which the rate may be adjusted annually, known as

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[80] Id. at 2-3.

[81] Id. at 3.

[82] Id.

[83] Id. at 3-4.

[84] Id. at 4.

adjustable rate mortgages ("ARMs").[85] The number of ARMs that FHA may insure in a single year is limited to 30% of the total number of mortgages insured under Title II during the preceding fiscal year.[86] The interest rate may be adjusted annually by a 1% increase or decrease from the rate in effect during the preceding year, with a lifetime change of a 5% increase or decrease from the rate reflected on the note.[87]

*Underwriting Guidelines:* FHA-insured loans must be underwritten in accordance with accepted practices of prudent lending institutions and FHA requirements. The FHA credit analysis worksheet is used to examine the applicant's personal and financial status, monthly shelter expenses, funds required for closing expenses, effective monthly income, and debts and obligations. As a general rule, the applicant's prospective housing expenses should not exceed 29% of his or her effective monthly income. The applicant's total obligations, including proposed housing expenses, should not exceed 41% of gross effective monthly income. Credit is automatically denied to applicants whose credit report indicates a delinquency of 90 days or more on a non-FHA-insured loan, or foreclosure on such a loan in the past 3 years.[88]

*Credit Limits:* The volume of FHA insurance commitments is subject to a fiscal year ceiling set by Congress. During fiscal year 2000, FHA may make insurance commitments totaling no more than $140 billion.[89]

*Reimbursement of Lenders*: FHA reimburses 100% of the unpaid principal balance of an FHA-backed mortgage as of the date of default, as well as any costs or fees that may accrue during the time the lender must spend disposing of the property.[90]

*Program Activity:* During fiscal year 1999, FHA underwrote $113.2 billion in insurance to insure the purchase or refinancing of 1,219,928 housing units. At the end of fiscal year 1999, FHA had $411.5 billion in insurance in force. From its inception in 1934 through the end of

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[85] Id. at 5.

[86] FHA is funded under two titles. Title I is funding for loans for mobile homes and improvements. Title II is funding for all other FHA programs. Telephone interview with Judy Heaney, Community Builder, U.S. Dep't of Hous. and Urban Dev. (June 16, 2000).

[87] U.S. Dept of Hous. and Urban Dev., Mortgagees' Handbook, 4000.2 REV-2, Chapter 6, Section 6-20, at 6-22, 6-23 (July 1991).

[88] Bruce E. Foote, Hous. Analyst, Domestic Soc. Policy Div., Congressional Research Serv., Order Code RS20530, FHA Loan Insurance Program: An Overview 5 (Mar. 30, 2000).

[89] Id.

[90] See 24 CFR § 203.402.

1999, FHA has insured nearly 27.9 million home loans at a mortgage volume of about $1,258 trillion.[91]

B. The Changing Face of FHA

1. The 1980s: Coming to Grips With Mortgage Fraud

Fraud involving FHA-backed mortgages for single-family residences is nothing new. For example, a 1986 HUD OIG semiannual report described an investigation in which a house in Milwaukee was purchased for $13,950 and resold to an unqualified buyer for whom the seller falsified a gift letter as evidence of a down payment to secure an FHA-backed mortgage. The buyer defaulted, the lender foreclosed on the house, and the FHA insurance fund suffered a loss of $43,100.[92] Another type of scheme that was prevalent in the 1980s involved "equity skimming." Equity skimming involves an investor who acquires a property, rents it to tenants, then collects the rent payments but does not make the mortgage payments. The property eventually goes into foreclosure, but only after the investor has collected sufficient rent to exceed his equity in the property.[93]

In response to such reports of widespread and growing abuse of the FHA mortgage program, HUD Secretary Samuel Pierce announced the formation of HUD's Single Family Task Force in fiscal year 1985. The mission of the Task Force was to conduct reviews of single family policy issues and analyze data from loans endorsed since 1980. On April 3, 1986, Secretary Pierce announced that the Task Force had issued its report recommending, among other things, that HUD aggressively pursue sanctions against those who abuse HUD programs, including seeking deficiency judgments against defaulting mortgagors; that HUD publicize actions taken against mortgagors, mortgagees, and others who abuse HUD programs; and that the Mortgagee Review Board take a firmer stand against mortgagees who violate HUD programs.[94] In addition to implementing the Task Force recommendations, the HUD Office of Housing issued internal directives requiring the close monitoring of early defaults on FHA-backed

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[91] Bruce E. Foote, Hous. Analyst, Domestic Soc. Policy Div., Congressional Research Serv., Order Code RS20530, FHA Loan Insurance Program: An Overview 5 (Mar. 30, 2000).

[92] Office of the Inspector Gen., U.S. Dept of Hous. and Urban Dev., Semiannual Report to the Congress (Oct. 1, 1985 - Mar. 31, 1986).

[93] Office of the Inspector Gen., U.S. Dept of Hous. and Urban Dev., Semiannual Report to the Congress 5 (Apr. 1986 - Sept. 1986).

[94] Office of the Inspector Gen., U.S. Dept of Hous. and Urban Dev., Semiannual Report to the Congress 7 (Oct. 1, 1985 - Mar. 31, 1986).

mortgages and lender claims as a means of detecting fraudulent schemes.[95] The Office of Housing stepped up its enforcement efforts to focus quickly on imprudent lenders and other parties, and to impose stringent monetary and administrative sanctions. That office also made instrumental programmatic changes to curb fraud, such as requiring detailed reviews of mortgage applications for previously owned HUD properties and eliminating a property owner's ability to refinance his mortgage by taking all the cash equity out of a property.[96]

In the 99th Congress, Senator Frank Lautenberg (D-NJ) and Representative Gerald D. Kleczka (D-WI) introduced S. 2112 and H.R. 4318 as the Single Family Mortgage Fraud Detection and Prevention Act of 1986. These bills would have amended the National Housing Act to direct HUD to take appropriate action to reduce losses under its single family mortgage insurance program. Those actions would have included (1) providing independent verification of the borrower's ability to pay by examining a sample of 10% of all approved loans and a sample of 20% of loans approved in areas where the default rate exceeded the national average by more than 120%, (2) requiring the examination of all lender data on loans that default within twelve months of origination, (3) requiring independent verification of appraisals involving investor-owned property which was acquired by the investor less than twelve months prior to a borrower's application for an FHA-insured loan on the property, and (5) requiring the use of FHA or VA appraisers in metropolitan areas, unless HUD certified to Congress that there was an insufficient number of such appraisers in the area and that the use of contract appraisers would not be more costly to HUD or VA.[97] The HUD IG opined that HUD's implementation of the recommendations of the Single Family Task Force would combat the types of fraud and abuse that S. 2112 targeted.[98] While S. 2112 was not enacted, Congress did pass some elements of the legislation in 1987 which required HUD program applicants to disclose their social security numbers and to consent to wage information verification.

Then, in 1989, Congress passed the Department of Housing and Urban Development Reform Act of 1989. Several provisions of the Act addressed fraud and losses in the FHA insurance programs. For example, the Act:

- Required issuance of an annual audited financial statement for each insurance fund;

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[95] The Office of Housing is the office within HUD that carries out FHA programs under the direction of the Assistant Secretary of Housing/Federal Housing Commissioner.

[96] Office of the Inspector Gen., U.S. Dept of Hous. and Urban Dev., Semiannual Report to the Congress 8 (Oct. 1, 1985 - Mar. 31, 1986).

[97] Memorandum from Bruce E. Foote, Hous. Analyst, Domestic Soc. Policy Div., Congressional Research Serv., to Bob Groves, Investigator, Permanent Subcomm. on Inv., Comm. on Gov'tal Affairs, U. S. Senate (June 15, 2000).

[98] Office of Inspector Gen., U.S. Dept of Hous. and Urban Dev., Semiannual Report to the Congress (Oct. 1, 1985 - Mar. 31, 1986).

- Prohibited insurance of mortgages on single-family houses that were not owner-occupied, unless the mortgagor was a state or local governmental or nonprofit entity;
- Required HUD to take appropriate action to reduce losses under the single family mortgage insurance programs;
- Required that at least one person acquiring ownership of an FHA-insured single family home be found creditworthy;
- Strengthened the Mortgagee Review Board within FHA to initiate and take disciplinary action, subject to court review, against any mortgagee engaging in actions violating FHA or fair housing requirements;
- Removed eligibility for investors for FHA-insured mortgages on single-family homes, except for the Section 203(k) rehabilitation program and loans to purchase FHA foreclosed properties; and
- Required persons seeking to assume mortgages originated after December 15, 1989, to be creditworthy.[99]

As a result of these reforms, the percentage of FHA-backed loans in foreclosure remained relatively stable between 1987 and 1994, at about 1.6%.

2. The Reinvention of HUD in the 1990s

The percentage of FHA-backed loans in foreclosure rose to more than 2.4% between 1995 and 1999. The percentage of conventional loans in foreclosure has not risen above 1% between 1979 and 1999.

In February 1993, HUD Secretary Henry Cisneros initiated a reinvention effort to make HUD more efficient and, more pressingly, to show Congress that HUD should not be dismantled. Secretary Cisneros said:

> A bold restructuring strategy has been put forth in the Administration's Reinvention Blueprint. Consolidation of programs, devolution of responsibility to localities and states, and the creation of entrepreneurial organizations will change the way [HUD] does business. Significant downsizing and streamlining is anticipated, reducing HUD's current work force of 12,000 today to fewer than 7,500 employees, and shrinking the field structure from 80 offices to roughly 60. HUD must change with the

[99] See Memorandum from Bruce E. Foote, Hous. Analyst, Domestic Soc. Policy Div., Congressional Research Serv., to Bob Groves, Investigator, Permanent Subcomm. On Inv., Comm. on Gov'tal Affairs, U. S. Senate, 2-3 (June 15, 2000) (citing P.L. 101-235, passed on Dec. 15, 1989).

times. But its mission endures, and the problems it addresses persist. The times call for HUD's reform, not its elimination.[100]

a. Liberalization of Controls Over Direct Endorsement Lenders

In 1995, FHA issued Mortgagee Letter 95-7, which significantly liberalized Direct Endorsement lender underwriting requirements.[101] HUD claimed that these changes would eliminate unnecessary barriers to home ownership, provide the flexibility to underwrite creditworthy non-traditional and under-served borrowers, and clarify certain underwriting requirements so that they are not applied in a discriminatory manner.[102] Significant changes the letter implemented include the following:

*Elimination of five-year test for income stability:* Previously, only those sources of income reasonably expected to last five years could be included in determining the borrower's income for qualifying purposes. That was reduced to an income expectation of three years.[103]

*Recognizing income from overtime and bonuses:* Previously, bonuses and overtime over a two year period (received or expected) could be counted as income. Periods of less than two years can now be considered for income calculations.[104]

*Recognition of part-time income:* Jobs consisting of less than a 40 hour work week can now be considered for income calculations. The lender must determine that the continuance of this income is likely.[105]

*Definition of long-term obligations extended to ten months:* Previously, debts lasting less than ten months had to be included in the amount of the debt affecting the borrower's ability to

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[100] U.S. Dept. of Hous. and Urban Dev., Why HUD (visited June 12, 2000) <http://www.hud.gov/whyhud.html> (1996 press statement by Secretary Cisneros defending HUD as cabinet level agency and explaining HUD restructuring strategy).

[101] Office of Inspector Gen., U.S. Dep't of Hous. and Urban Dev., Audit Report # 00-SF-121-001, Single Family Production Home Ownership Centers 1 (Mar. 30, 2000).

[102] U.S. Dep't of Hous. and Urban Dev., Mortgagee Letter # 95-7, at 1-6 (Jan. 27, 1995).

[103] Id. at 1.

[104] Id. at 1-2.

[105] Id. at 2.

satisfy the mortgage payments. Now, only those debts extending ten or more months must be considered.[106]

*Elimination of child care as recurring debt:* Child care is no longer considered in the computation of debt-to-income ratios because, according to HUD, most families assessing their financial priorities will find alternate means of caring for their young children if such costs become burdensome.[107]

*Using cash saved at home as funds to close:* Borrowers who have saved cash at home and are able adequately to demonstrate the ability to do so are permitted to have this money included as an acceptable source of funds to close the mortgage.[108]

*Cash accumulated with private savings clubs:* These funds can be utilized if the borrower is able adequately to document the accumulation of those assets to the satisfaction of the underwriter.[109]

*Flexibility in qualifying ratios and compensating factors:* Payment-to-income ratios may be exceeded where significant compensating factors exist.[110]

*Unnecessary repair requirements on FHA appraisals:* DE underwriters should exercise their authority to delete conditions that require unnecessary and cosmetic repair requirements from FHA appraisals when those requirements have little or nothing to do with the safety and soundness of the property.[111]

*Automated underwriting systems and use of artificial intelligence in underwriting:* HUD approved lenders may use automated underwriting systems for approving FHA-insured mortgages as long as the criteria are met for loan approval. Artificial intelligence systems may be used for loan approvals only, and loans rejected by an artificial intelligence system must be

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[106] Id.

[107] Id.

[108] Id.

[109] Id. at 2-3.

[110] Id. at 3.

[111] Id. at 4.

reviewed by a human underwriter. A DE underwriter must still execute the normal documents required on FHA-insured mortgages.[112]

*Alternate qualifying methods for housing finance agencies:* HUD approved state and local housing finance agencies are permitted to adopt additional methodologies in qualifying borrowers for FHA-insured mortgages beyond the application of income ratios.[113]

*DE approval for branch offices:* Once a lender obtains unconditional DE status for any one of its offices, additional branch offices that become approved to do business with HUD are automatically granted DE approval.[114]

*Alternate documentation – revised instructions:* If a former employer is no longer in business at the time of the underwriting and a verification of past employment cannot be made, the underwriter need only verify by telephone all current employment. Also, the requirement that the lender obtain statements covering the most recent three month period for bank statement transactions can be met by obtaining the most recent two original bank statements. The lender may also utilize an electronic retrieval service for W-2 and tax return information, but cannot charge the borrower for that service.[115]

*Underwriter approvals – appraisal experience:* Previously, an individual could qualify as a HUD-approved underwriter only by documenting that he had taken course work that would constitute one year's worth of full-time experience reviewing appraisals. Now, individuals may also qualify by taking a course called, "Seminar on Appraisal Techniques," sponsored by the Mortgage Bankers Association of America.[116]

*Mortgage credit certifications:* DE lenders may consider tax credits resulting from mortgage credit certifications as a direct reduction in an applicant's housing expense.[117]

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[112] Id.

[113] Id. at 4-5.

[114] Id. at 5.

[115] Id.

[116] Id. at 5-6.

[117] Id. at 6.

b. Increase in Mortgage Insurance Premiums

The MMIF, which is used to fund FHA Single Family Insured Programs, was designed to be actuarially sound and self-supporting. In fiscal year 1987, however, the fund barely broke even, and in 1988 the MMIF suffered its first net loss. In 1989, the MMIF's income was insufficient to cover losses.[118] The MMIF had about $4 billion in reserves at the end of fiscal year 1987. By the end of fiscal year 1991, the MMIF's reserves had shrunk to only $871 million.[119]

As a result, in 1991, Congress authorized HUD to increase FHA insurance premiums to keep the fund solvent. Prior to that time, on a 30 year mortgage, a borrower paid a one-time Mortgage Insurance Premium ("MIP") of 3.8% of the amount borrowed. As of July 1, 1991, the borrower had to pay an additional annual premium of 0.5% in addition to the 3.8% one-time payment.[120] In 1994, Congress enacted legislation to change the MIP calculations yet again to reflect the risk of the loans being insured.[121] For any loan insured on or after October 1, 1994, the borrower pays an up-front mortgage insurance premium of 2.25% of the loan amount. Thereafter, the borrower pays an annual insurance premium whose amount and duration are determined by the size of the down payment: (1) A borrower who makes a down payment in excess of 10% will pay an annual insurance premium of 0.5% of the loan balance for the first 11 years of the loan, (2) a borrower who makes a down payment of 5% to 10% will pay an annual premium of 0.5% for the first 30 years of the loan, and (3) a borrower who makes a down payment of less than 5% will pay an annual premium of 0.55% of the loan balance for 30 years.[122]

c. HUD 2020 Management Reform Plan

The HUD reinvention effort expanded on June 26, 1997, when Secretary Andrew Cuomo announced a new management reform plan for HUD.[123] The plan -- dubbed "HUD 2020" --

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[118] Bruce E. Foote, Hous. Analyst, Domestic Soc. Policy Div., Congressional Research Serv., Order Code RS20530, FHA Loan Insurance Program: An Overview 4 (Mar. 30, 2000).

[119] Id.

[120] Telephone interview with Joe Rothchild, Office of Evaluation, Office of the Comptroller, U.S. Dep't of Hous. and Urban Dev. (June 16, 2000).

[121] Bruce E. Foote, Hous. Analyst, Domestic Soc. Policy Div., Congressional Research Serv., Order Code RS20530, FHA Loan Insurance Program: An Overview 4 (Mar. 30, 2000).

[122] Id.

[123] U.S. Dep't of Hous. and Urban Dev., Press Release: Cuomo Announces Historic Management Reforms For HUD To Stamp Out Waste, Fraud and Abuse and Improve Performance 1 (dated June 26, 1997)

aimed "to transform HUD from the poster child for inept government that has been plagued for years by scandal and mismanagement into a new HUD, a HUD that works."[124] The 2020 Management Reform Plan included the following reforms:

- Creating a new Enforcement Division to fight waste, fraud and abuse;
- Retraining some HUD employees as Community Builders to serve as HUD's service representatives for the public and retraining other employees as Public Trust Officers to monitor recipients of HUD funding;
- Consolidating over 300 HUD programs and activities into 71;
- Consolidating routine paperwork by HUD offices around the country in more efficient "back office" processing centers;
- Conducting the first comprehensive evaluation involving physical inspections and financial audits of HUD's housing portfolio;
- Establishing a new financial information management system;
- Reducing the size of HUD's staff from the current 10,500 to 7,500 by the end of the year 2000; and
- Establishing new performance-based evaluation systems.[125]

1) Establishment of the Homeownership Centers

In addition, the 2020 Management Reform Plan called for the consolidation of all single family operations from 81 locations across the country into three Homeownership Centers ("HOCs"). The number of HOCs was later increased to four, which are presently located in Philadelphia, Pennsylvania; Atlanta, Georgia; Denver, Colorado; and Santa Ana, California. Secretary Cuomo predicted,

> When fully implemented, the HOC will perform functions which are now performed in individual offices. Specifically, they will be staffed to perform the following core functions: insurance endorsements; operational post-endorsement technical reviews; fee panel oversight; underwriting;

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<http://www.hud.gov/pressrel/pr97-109.html>.

[124] Id.

[125] Id.

> servicing advice and guidance to mortgagees; contractor oversight/management; loss mitigation; REO sales; marketing and outreach; quality control post-endorsement technical reviews; lender monitoring; sanctions; and audits/investigations.[126]

There are several divisions with each HOC, each of which performs different functions. These divisions include the following:

*Processing and Underwriting Division:* Responsible for processing applications for insurance endorsement; issues Mortgage Insurance Certificates; provides advice and guidance on FHA underwriting guidelines; assigns FHA case numbers to lenders.[127]

The Technical Services Branch is part of the Processing and Underwriting Division. That branch is responsible for conducting HUD approval of condominiums and new construction; processing complaints about existing and new construction; completing master conditional commitments or bulk appraisals over new FHA-insured housing subdivisions; and giving environmental approvals on new construction.[128]

*Quality Assurance Division (QAD):* Evaluates loan quality; monitors lender performance; administers sanctions against program participants; assists in investigations and audits of lenders and other program participants.[129] The QAD Office of Lender Activities is responsible for conducting on-site reviews to monitor the origination and servicing performance of FHA approved lenders (1) to assure that mortgagee practices are in compliance with applicable requirements; (2) to uncover mortgage finance fraud and abuse of FHA programs; (3) to identify mortgagees representing a high risk to the FHA MMIF; (4) to take appropriate actions to mitigate loss; and (5) to provide consistency in the resolution of problems identified. The QADs had a goal of completing 900 field reviews of lenders (225 per HOC) for fiscal year 1999,

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[126] U.S. Dept. of Hous. and Urban Dev., 2020 Management Reform Plan: Single Family Housing 12-13 (visited June 12, 2000) < http://www.hud.gov/reform/mrbus1n1.;html>.

[127] U.S. Dept. of Hous. and Urban Dev., About Homeownership Centers 1 (visited June 13, 2000) <http://www.hud.gov/fha/sfh/hoc/hocabout.html>.

[128] Telephone interview with Judy Heaney, Community Builder, U.S. Dep't of Hous. and Urban Dev. (June 16, 2000).

[129] U.S. Dept. of Hous. and Urban Dev., About Homeownership Centers 1 (visited June 13, 2000) <http://www.hud.gov/fha/sfh/hoc/hocabout.html>.

which they exceeded by completing 932 field reviews.[130] Their goal for fiscal year 2000 is also 900 lender reviews.[131]

The Approval/Re-certification/Review Tracking System ("ARRTS") is a database used to track the status and results of QAD monitoring reviews. This system contains data fields that collect such information as the date on which the review began, the status of the review, the number of loans reviewed, and the number of indemnification agreements executed. QAD field monitors complete a form that QAD staff at the HOC later uses to enter such data about the review into ARRTS. When properly used, the system should provide a measure of quality assurance effectiveness in reducing HUD's potential for losses.[132]

*Marketing and Outreach Division:* Promotes home buyer education initiatives; fosters good industry/community relations; negotiates partnership agreements with state and local governments, nonprofit organizations, and community organizations; implements advertising campaigns.[133]

*Real Estate Owned Division:* Oversees sale and management of HUD Real Estate Owned ("REO") properties to which HUD has received title as a result of a foreclosure action.[134]

*Administrative Support Division:* Responsible for personnel administration; budgeting; contract administration; automated system support.[135]

*Customer Assistance Staff:* Responds to requests for assistance from customers; provides case status information; troubleshoots problems encountered by customers.[136]

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[130] General Accounting Office, GAO/RCED-00-112, Single Family Housing: Stronger Oversight of FHA Lenders Could Reduce HUD's Insurance Risk 14 (Apr. 28, 2000).

[131] Office of Inspector Gen., U.S. Dep't of Hous. and Urban Dev., Audit Report # 00-SF-121-001, Single Family Production Home Ownership Centers 27 (Mar. 30, 2000).

[132] Id. at 57.

[133] U.S. Dept. of Hous. and Urban Dev., About Homeownership Centers 1 (visited June 13, 2000) <http://www.hud.gov/fha/sfh/hoc/hocabout.html>.

[134] Id.

[135] Id.

[136] Id.

2) The Real Estate Assessment Center

The Real Estate Assessment Center ("REAC") is responsible for assessing the overall physical and financial condition of HUD's vast housing portfolio, enabling the Department to better target its monitoring and enforcement resources. Because other HUD organizations are so dependent upon its work, REAC is generally considered the linchpin of HUD's 2020 Management Reform Plan.[137]

REAC's functions regarding HUD's Single Family Insured Programs, however, are largely limited to appraiser oversight. REAC's Single Family Appraisal Quality Assessment Team conducts reviews of appraisals for FHA-insured single family homes. The reviews assess the accuracy and completeness of FHA appraisal reports to reduce the probability of costly and unexpected repairs to homebuyers. When homebuyers do not receive adequate appraisals, they may be unaware that large repairs will be required to make their homes habitable and sonsequently default on their FHA insured mortgages. In addition, the Single Family Appraisal Quality Assessment Team created a standard for appraisal knowledge by requiring appraisers to pass the FHA appraiser exam to be eligible to perform FHA appraisals. These activities support the reforms initiated in the Homebuyer Protection Plan, which "reinvented" FHA's appraisal process.[138]

C. Increase in Defaults and Foreclosures

Between fiscal years 1997 and 1999, the number of single family mortgage loans that FHA insured grew from approximately 800,000 to nearly 1.3 million -- a 63% increase. For the three years combined, FHA insured over 3 million mortgages with a total value of $292 billion.[139]

This dramatic increase in endorsements, however, has been accompanied by a similarly arresting increase in delinquency and foreclosure rates. In fact, there has been "an increase of over 50 percent in FHA loan foreclosure rates over the last five years from 1.45 percent in 1994 to 2.20 percent through three quarters of 1999. Similarly, Mortgage Banker Association data shows an increase of over 18 percent in FHA delinquency rates (from 7.26% to 8.57%) during

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[137] Office of Inspector Gen., U.S. Dep't of Hous. and Urban Dev., Semiannual Report to the Congress, (as of Sept. 30, 1998) **<http://www.gov.oig.oigindex.html>**

[138] U. S. Dep't of Hous. and Urban Dev., Single Family Appraisal Quality Assessment 1 (visited June 19, 2000) <http://www.hud.gov/reac/products/prodsfa/cfm>

[139] General Accounting Office, GAO/RCED-00-112, Oversight of FHA Lenders: Single Family Housing, Page 6 (April 28, 2000).

the same period."[140] The Mortgage Bankers Association National Delinquency Survey report for the fourth quarter of 1999 explains that, "The inventory of loans in foreclosure at the end of the quarter declined for conventional loans, but rose for FHA and VA loans. The percentage of FHA loans in foreclosure increased 3 basis points to 2.01 percent."[141]

D. HUD's Response

HUD has announced a series of programs designed to curb fraud and waste in the Single Family Insured Program. A brief description of these programs follow.

1. The Loss Mitigation Program

Until April 1996, FHA-insured homeowners who encountered financial difficulties had the benefit of the FHA Assignment Program, which was designed to provide temporary relief for mortgagors who experienced financial difficulties resulting in mortgage default. The relief the Assignment Program offered was in the form of a mortgage assignment to HUD with a forbearance plan that offered reduced or suspended payments for a period of up to 36 months. HUD concedes, however, that words, the Assignment Program generated substantial losses to FHA without achieving an acceptable level of success in curing mortgage defaults.[142]

The Assignment Program was terminated in April 1996 by the Balanced Budget Downpayment Act. Its replacement, FHA's Loss Mitigation Program, is expected to reduce the number of foreclosures and the costs associated with foreclosures. Under this program, lenders are compensated for using one of five loss mitigation tools to help borrowers in default avoid foreclosure:

*Special forbearance:* Allows for a period of reduced or suspended payments for the borrower. This tool is designed to provide relief to borrowers with temporary financial problems.

*Mortgage Modification:* Results in the lowering of the interest rate, or the extension of the term of the mortgage, to reduce monthly payments to affordable levels for the mortgagor. Mortgage modifications are designed for borrowers who have recovered from financial distress, but whose net income has permanently dropped from its level prior to default.

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[140] Office of Inspector Gen., U.S. Dep't of Hous. and Urban Dev., Audit Report # 00-SF-121-001, Single Family Production Home Ownership Centers *iii* (Mar. 30, 2000).

[141] Mortgage Bankers Association, National Delinquency Survey for the 4th Quarter of 1999 1 (last modified Mar. 29, 2000) < http://www.mbaa.org/marketdata/nds/0499.html>.

[142] U.S. Dep't of Hous. and Urban Dev., FHA's Foreclosure Alternatives 1 (last modified May 17, 2000) < http://www.hud.gov/local/okl/slm/fhamitig.html>.

*Partial claim:* Provides essentially a second loan on the property. FHA pays the amount necessary to cure the default, and a promissory note is issued to secure repayment of the partial claim. The second loan is interest free, and is not required to be paid until the first mortgage matures, is prepaid, or the borrower vacates the property.

*Preforeclosure sale:* A borrower's home is sold prior to foreclosure and the borrower is relieved of his mortgage obligation. The borrower's debt is forgiven.

*Deed-in-lieu of foreclosure:* Voluntary transfer of the deed to the lender; used primarily when pre-foreclosure sale fails.[143]

As part of the HUD 2020 Management Reform, the National Servicing and Loss Mitigation Center in Oklahoma City became fully operational in February 1998. The Center consolidated the loss mitigation function into a single centralized office and created a single point of contact for lenders and borrowers.[144]

A September 1999 HUD OIG report found that the utilization of home retention, loss mitigation tools had increased dramatically in the preceding year. HUD has paid in excess of $26.9 million in loss mitigation claims from October 1, 1996, to May 31, 1999. Over $19 million, or 71% of this amount, was paid in fiscal year 1999.[145]

The HUD OIG report found a lack of program oversight and weaknesses in the monitoring of mortgagees.[146] Specifically, the report found that HUD needed to improve its review of loss mitigation claims, monitoring and oversight of lenders' use of loss mitigation tools, and the completeness and reliability of default status data contained within its Single Family Default Monitoring System.[147]

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[143] Office of Inspector Gen., U.S. Dep't of Hous. and Urban Dev., Audit Report # 99-DE-121-0001, Department of Housing and Urban Development's Loss Mitigation Program 1 (Sept. 30, 1999).

[144] Office of Inspector Gen., U.S. Dept of Hous. and Urban Dev., Semiannual Report to the Congress (Apr. 1, 1999 - Sept. 30, 1999).

[145] Office of Inspector Gen., U.S. Dep't of Hous. and Urban Dev., Audit Report # 99-DE-121-0001, Department of Housing and Urban Development's Loss Mitigation Program 2 (Sept. 30, 1999).

[146] Id. at *i*.

[147] Servicing lenders must report to HUD once each month the current status of all loans that are in default for 90 days or more. The SFDMS is the only database that stores and maintains default status codes. HUD's only other means of obtaining default status data is from the Government National Mortgage Association default data, which is compiled on a quarterly basis, or by calling the lender directly to determine the status of individual FHA loans. Id. at 23-24.

Although the use of loss mitigation tools is increasing and thereby forestalling many FHA foreclosures, HUD continues to see an increase in foreclosure rates. Since there is a time lag between loss mitigation activities and foreclosure actions, and since the majority of loss mitigation activities have occurred in the last year, it is still too early to determine whether the program will ultimately be successful in reducing foreclosures and keeping families in their homes.[148]

2. Credit Watch

Credit Watch is a system HUD implemented in May 1999 to evaluate the performance of lenders and track loans they have made so that, even when a loan is sold to another lender and later goes into default, the originating lender for that loan is credited with the default. Credit Watch enables HUD to terminate the loan origination authority of lenders with excessive defaults and insurance claims on FHA-insured mortgages. Pursuant to the program, HUD may terminate the loan origination authority of any lender whose default and claim rates on mortgages insured by FHA during the preceding 24 months exceeds both the national average and 300% of the average rate for the Field Office serving the lender's geographic location. Similarly, HUD may place on "credit watch" the lenders whose default and claim rates exceeds both the national average and 200% of the corresponding HUD field office average. While on credit watch, the lender can continue to originate FHA-insured loans, but its performance receives greater scrutiny from HUD. Because the program regulations pertain only to lenders that originated the troubled loans, HUD does not always hold accountable the DE lenders that underwrote and approved the loans.

The first round of Credit Watch terminations occurred on September 15, 1999, when HUD terminated 26 FHA lenders because they had default/claim rates that exceeded the national rate and 300% of the HOC rate. Another 100 lenders were placed on the Credit Watch list for monitoring. One of the 26 FHA lenders, Capitol Mortgage Banks, Inc., successfully challenged HUD's authority to take this action in federal court in Baltimore.[149] Specifically, the court found that FHA exceeded its authority in terminating Capitol Mortgage Bankers, and rules that the Credit Watch regulation was unlawful and invalid. The court also ruled that HUD must give lenders an opportunity to take corrective action before termination. For these reasons, the court ordered the reinstatement of Capitol Mortgage Bankers as an FHA-approved lender. HUD has appealed the district court's decision.

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[148] Office of Inspector Gen., U.S. Dept of Hous. and Urban Dev., Semiannual Report to the Congress (Apr. 1, 1999 - Sept. 30, 1999).

[149] See Capitol Mortgage Banker, Inc. v. Cuomo, 77 F.Supp. 690 (D.Md. 1999).

In contrast, on June 7, 2000, a federal district court in Detroit, Michigan, ruled in HUD's favor by denying a lender the temporary restraining order it sought against its termination pursuant to Credit Watch. Thus, the legality of Credit Watch is still very much in question.[150]

3. The Homebuyer Protection Plan

In June 1998, HUD first announced a new Homebuyer Protection Plan "to improve home appraisals for over 1 million families who purchase homes each year with HUD-insured mortgages."[151] HUD described this plan as featuring six key components:

- A new consumer education campaign about appraisals and inspections conducted by HUD, the National Association of Realtors, and the Mortgage Bankers Association of America.[152]

- Mandatory testing of all appraisers to determine if they are qualified to perform FHA appraisals. Approximately 30,000 private appraisers around the nation, who perform mandatory appraisals before the sale of every home financed with an FHA mortgage, will be tested. Appraisers flunking the test will not be certified to perform FHA appraisals until they pass the exam, which is intended to help ensure that appraisers know and understand FHA requirements.[153]

- More thorough and reliable appraisals designed to uncover significant defects in homes.[154] HUD sought to accomplish this change through revision of its comprehensive valuation package ("CVP"), which consists of three parts. The first part is the Uniform Residential Appraisal Report ("URAR"), which was not modified. The second part is the "Valuation Conditions – Notice to the Lender" form ("VC sheet"), which the appraiser is required to complete to reflect readily observable information relevant in determining the property's "as-repaired" value. HUD revised the VC sheet to reflect more specifically conditions relevant to determining whether the property meets HUD's Minimum Property Standards or Requirements ("MPS/MPR"), but HUD nevertheless maintains that the requirements of the new VC sheet are not materially different from the previous version

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150 Telephone interview with Kevin Simpson, Counsel, U.S. Dep't of Hous. and Urban Dev. (June 19, 2000).

151 U.S. Dep't of Hous. and Urban Dev., Press Release: Cuomo Announces New Initiative to Protect Consumers from Buying HUD-Insured Homes with Undetected Defects 1 (dated June 10, 1999) <http://www.hud.gov/pressrel/pr99-99.html>.

152 Id.

153 Id.

154 Id.

of the VC sheet.[155] The third part is the Homebuyer Summary, which the appraiser must prepare if he notes any MPS/MPR nonconformity on the property.

- Mandatory disclosure of detected home defects to home buyers through the Homebuyer Summary.[156] The appraiser must sign the Homebuyer Summary and provide it as part of the CVP to the lender. The lender is then responsible for providing each prospective borrower with the Homebuyer Summary when the appraiser has noted a nonconformity on the property. The lender's Direct Endorsement underwriter must review the Homebuyer Summary to assure that it is complete. Borrowers must receive the Home buyers Summary at least five days prior to the loan closing, and must sign and date it to acknowledge their receipt of it. The lender must include a copy of the summary in the case binder it submits to FHA for insurance endorsement. Repair items must be completed prior to the loan closing.[157]

- Automated evaluation of appraisals. HUD will establish a system that enables it to collect appraisal data electronically and track trends in appraisal quality. The system was scheduled to be implemented nationwide by the end of 1999. The new system is expected to enable HUD to perform high-speed computer-generated reviews of the performance of all appraisers, so that appraisers found to make inaccurate appraisals can be spotted and targeted for further review and possible enforcement action. HUD has developed a series of statistical indicators to help target its appraiser oversight activities, particularly field review activities. The indicators work by comparing home values derived by appraisers and the techniques used to establish the values. Individual indicators are then combined into a single appraisal score using a statistically derived weighting system.[158]

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[155] Office of Assistant Secretary for Hous.-Fed. Hous. Comm'r, U.S. Dep't of Hous. and Urban Dev., Mortgagee Letter 99-32 at 1 (dated Nov. 12, 1999) **<http://www.hudclips.org/sub_nonhud...MLET&u=./** hudclips.cgi&p=1&r=28&f=G>.

[156] U.S. Dep't of Hous. and Urban Dev., Press Release: Cuomo Announces New Initiative to Protect Consumers from Buying HUD-Insured Homes with Undetected Defects 1 (dated June 10, 1999) <http://www.hud.vog/pressrel/pr99-99.html>.

[157] Office of the Assistant Secretary for Hous.-Fed. Hous. Comm'r, U.S. Dep't of Hous. and Urban Dev., Mortgagee Letter 99-18 at 2 (dated June 28, 1999) **<http://www.hudclips.org/sub_nonhud...MLET&u=./hudclips.cgi&p=1&r=43&f=G>.**

[158] U.S. Dep't of Hous. and Urban Dev., Press Release: Cuomo Announces New Initiative to Protect Consumers from Buying HUD-Insured Homes with Undetected Defects 1 (dated June 10, 1999) <http://www.hud.vog/pressrel/pr99-99.html>.

- Stricter enforcement action to suspend poorly performing appraisers from working for FHA.[159]

Although at the time of its announcement, HUD planned to phase in all aspects of the Homebuyer Protection Plan "over the next few weeks[,]"[160] HUD ultimately delayed until March 1, 2000 implementation of the regulatory changes relating to enforcement actions against appraisers who perform appraisals that are not in compliance with FHA requirements.[161] Accordingly, neither GAO nor HUD-OIG has evaluated the impact, if any, of these regulatory changes.

In addition, under the plan, home buyers are required to sign and date a new informational form entitled, "For Your Protection: Get a Home Inspection," before they purchase a home with an FHA mortgage.[162] This form replaced the "Importance of Home Inspections" form. According to HUD, "The [new] form advises [home buyers] in plain English to get a home inspection in addition to an appraisal."[163] This form advises buyers that FHA does not guarantee the value or condition of the property; that an appraisal is not a home inspection; and that the borrower has the right to have the house inspected by a professional home inspector. The home buyer must sign and date the form on or before the date that the sales contract is executed for all transactions involving FHA mortgage insurance on existing property. The lender must include a copy of the signed and dated form in the case binder it submits to FHA for insurance endorsement.[164]

4. The Fraud Protection Plan

HUD's Fraud Protection Plan is an outgrowth of its Baltimore Task Force. Working with Senator Mikulski, HUD launched the Baltimore Task Force in April 2000 to gather information

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[159] Id.

[160] Id.

[161] U.S. Dept of Hous. and Urban Dev., Mortgagee Letter # 99-32 at 2 (dated Nov. 12, 1999) <http://www.hudclips.org/sub_nonhud...MLET&u=./hudclips.cgi&p=1&r=28&f=G>.

[162] Office of the Assistant Secretary for Hous.-Fed. Hous. Comm'r, U.S. Dep't of Hous. and Urban Dev., Mortgagee Letter 99-18 at 2 (dated June 28, 1999) **<http://www.hudclips.org/sub_nonhud...MLET&u=./hudclips.cgi&p=1&r=43&f=G>.**

[163] U.S. Dep't of Hous. and Urban Dev., Press Release: Cuomo Announces New Initiative to Protect Consumers from Buying HUD-Insured Homes with Undetected Defects 1 (dated June 10, 1999) <http://www.hud.vog/pressrel/pr99-99.html>.

[164] Office of the Assistant Secretary for Hous.-Fed. Hous. Comm'r, U.S. Dep't of Hous. and Urban Dev., Mortgagee Letter 99-18 at 2-3 (dated June 28, 1999) **<http://www.hudclips.org/sub_nonhud...MLET&u=./hudclips.cgi&p=1&r=43&f=G>.**

on the cause and extent of mortgage frauds and resulting foreclosures, and to develop recommendations that would both benefit Baltimore and serve as a model for FHA programmatic reform throughout the nation. FHA declared a 90-day moratorium on foreclosures of FHA-insured loans in Baltimore City, which enabled HUD to send a "SWAT Team" to Baltimore to identify fraud or predatory practices involved in FHA-backed loans before foreclosures and to help as many homeowners as possible avoid foreclosures. HUD staff intensively reviewed case files for the 350 FHA borrowers in Baltimore who had received a notice of intent to foreclose after January 1, 2000, and found evidence of fraud or predatory lending in 50 to 60 cases. The SWAT team intends to refer these cases to appropriate law enforcement authorities. To help defaulting Baltimore homeowners avoid foreclosure, FHA attempted to contact all borrowers with impending foreclosures with the goal of focusing resources on loss mitigation assistance. In "Hot Zone" areas with high default and foreclosure rates, FHA will establish teams of loss mitigation specialists to work with lenders and borrowers to ensure that every effort is made to help families remain in their homes. In addition, FHA contacted the corresponding lender for each borrower to ensure that the lenders were properly evaluating borrowers and offering appropriate foreclosure avoidance options.

At its public forum in Baltimore on May 19, 2000, HUD announced its Fraud Protection Plan, which seeks to apply the Baltimore Task Force's recommendations to the rest of the country. The Plan has two primary emphases: (1) Providing relief to FHA borrowers already in default, especially those who have been victimized by abusive lending practices; and (2) strengthening FHA endorsement and fraud detection procedures to prevent predatory practices from occurring in the first place.

To achieve its first goal of assisting FHA borrowers already in default, HUD proposes to issue vouchers for fund foreclosure avoidance counseling at HUD-approved locations. By expanding the availability and improving the quality of counseling, HUD seeks to help homeowners make better use of currently available loss mitigation tools, such as mortgage modification and partial loan forgiveness. HUD also intends to approve new software to assist counselors in advising victims of mortgage fraud.

For FHA borrowers saddled with inflated mortgages that stem from inflated appraisals, HUD plans to direct mortgage lenders to write down their mortgages to a level consistent with fair market appraisals. In situations where the lender refuses to honor this demand, FHA intends to intervene, cancel the existing mortgage, and refinance the mortgage at the fair market value. The FHA insurance fund would bear the cost of redeeming the mortgage at the fair market value. It is estimated that the cost to the fund in Baltimore alone could reach $30 million. In addition, HUD will instruct lenders to issue a "credit repair" letter to ensure that the victim's credit record is set straight. HUD also intends to send teams of loss mitigation specialists to "Hot Zones," which it defines as areas with high concentrations of FHA foreclosures, to ensure that every effort is made to help families remain in their homes.

To achieve its second goal of stopping predatory practices from undermining FHA's ability to promote housing opportunity, FHA will implement an automated system to review the sales price history of properties prior to FHA insurance endorsement. In our opinion, this is one of the Plan's best initiatives because it will disclose when a house purchased for $10,000 is sold three months later for $80,000, thereby flagging the "flip." In addition, FHA will form "SWAT Teams," modeled on the Baltimore team, to target abusive appraisal practices in Hot Zones around the country. FHA also intends to suspend abusive real estate brokers from future participation in FHA programs, but it has not provided any specific information regarding how it plans to accomplish these suspensions. Additionally, FHA intends to customize its data on housing sales to develop early warning indicators of foreclosure "Hot Zones."

FHA is also launching a new Appraisal Watch system modeled after the Credit Watch system now targeted to lenders. The goal of Appraisal Watch is to identify appraisers with a record of faulty appraisals and abusive practices, terminate them from FHA programs, and, if appropriate, pursue legal action.

#### 5. Mortgage Credit Scorecard Project

The Mortgage Credit Scorecard Project is a new automated underwriting system that gives credit scores for lenders by establishing a profile to be used to evaluate loan information that is entered into the automated underwriting system. At present, 1/3 of all FHA loans are processed through this system. The number of mortgages processed through the system is expected to increase to 50% within the next year. According to HUD, this reform is still in the "drawing board" stage.[165]

## V. Agency Criticisms of HUD

### A. General Accounting Office

#### 1. GAO on HUD's Lack of Lender Oversight

Every year, HUD, through FHA, insures billions of dollars in home mortgage loans made by private lenders. From fiscal years 1997 to 1999, the number of single-family mortgage loans that FHA insured grew from approximately 800,000 to nearly 1.3 million – a 63% increase. For the three years combined, FHA insured over three million mortgages with a total value of $292 billion. During fiscal year 1999 alone, FHA insured 1.3 million mortgages valued at about $124 billion.

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[165] Telephone interview with Judy Heaney, Community Builder, U.S. Dep't of Hous. and Urban Dev. (June 16, 2000).

As of December 1999, HUD had approved roughly 9,950 lending institutions to participate in FHA's mortgage insurance programs for single-family homes. To receive such approval, lenders must submit to HUD an application form, a fee, and supporting documentation including the resumes of senior corporate officers, certified financial statements, and photographs and floor plans of the lender's main office. HUD uses this information to determine if elements such as outstanding federal debts, recent bankruptcies, derogatory credit, or other factors make them ineligible for the program. Lenders must be annually re-certified by HUD to maintain FHA-approved status. Once lenders receive such approval from HUD, they have the authority to originate FHA-backed mortgages.

Approximately 2,900 of the FHA-approved lending institutions also have direct endorsement authority, meaning that they can determine the eligibility of loans for FHA mortgage insurance without HUD's prior review. While FHA insures lenders against nearly all losses resulting from foreclosed loans, it relies almost exclusively on the DE lenders to underwrite the loans.

Recent cases of mortgage fraud across the country have raised concerns about HUD's oversight of these lenders. For example, in December 1999, HUD OIG and the Department of Justice announced criminal charges against thirty-nine California mortgage lenders, real estate professionals, and other persons accused of obtaining more than $110 million in fraudulent FHA-insured loans. At the request of Senator Susan M. Collins (R-ME) and Representative Rick Lazio (R-NY), GAO has prepared a report entitled, "Single Family Housing: Stronger Oversight of FHA Lenders Could Reduce HUD's Insurance Risk." The report addresses the following questions: (1) How well does HUD ensure that lenders granted DE authority by FHA are qualified to receive such authority? (2) To what extent does HUD focus on high-risk lenders in monitoring the lenders participating in FHA's mortgage insurance programs? (3) To what extent is HUD holding lenders accountable for poor performance? To address these questions, GAO reviewed the activities of HUD headquarters and its four HOCs located in Atlanta, Georgia; Denver, Colorado; Philadelphia, Pennsylvania; and Santa Ana, California.

a. Approval of Lenders to Receive DE Authority

HUD's process for granting FHA-approved lenders DE authority provides limited assurance that lenders receiving this authority are qualified. According to HUD's guidance, FHA-approved lenders seeking DE authority must demonstrate "acceptable performance" in underwriting at least fifteen mortgage loans, which undergo evaluations, known as *preclosing reviews*, by HUD's HOCs. However, the guidance does not define what would constitute overall acceptable performance on the fifteen loans. In the absence of such a clear definition, the HOCs have interpreted what constitutes acceptable performance differently, and accordingly their standards for approving lenders for DE authority have been inconsistent. In the six months prior to GAO's 1999 visits, the HOCs granted DE authority to a total of thirty-six lenders. While many of these lenders had demonstrated proficiency in underwriting mortgages, many others made multiple and serious underwriting errors. Overall, twelve of the thirty-six lenders had received four or more "poor" ratings from the HOCs for their last fifteen preclosing reviews. According to GAO, the vagueness and inconsistent application of HUD's approval standards constitutes a risk to the insurance program. GAO recommends that HUD improve the process for granting lenders DE authority by developing specific standards for overall acceptable performance in pre-closing reviews and ensuring that the HOCs comply with these standards.

b. Monitoring of Lenders

1) On-Site Lender Reviews

Contrary to HUD's guidance, the HOCs' monitoring of lenders does not adequately focus on the lenders and loans that pose the greatest insurance risks to HUD. On-site evaluations of lenders' operations – known as *lender reviews* – are one of HUD's primary tools for assessing the quality of lenders' mortgage-lending practices. HUD's guidance states that 85% of the lender reviews should be targeted at high risk lenders, while 15% should be selected randomly. HUD's guidance also stresses the importance of using risk analysis to allocate a larger share of monitoring resources to program activities that pose the highest risk to HUD. GAO found that lender reviews by HUD have increased in recent years, as HUD has placed greater emphasis on performing on-site evaluations of lenders' operations.

However, GAO found that the HOCs have often not reviewed the lenders and loans that they consider to be the highest risks. For example, although the Philadelphia HOC conducted reviews of 228 lenders during fiscal year 1999, it reviewed only 39 of the 131 high-risk lenders (about 30%) that it designated as high priority for review that year. HUD officials told GAO that the lack of experienced staff and limited travel funds impeded HUD's ability to visit and review the riskiest lenders. Furthermore, GAO noted that HUD placed too much emphasis on meeting numeric goals instead of targeting high-risk loans. GAO recommended that HUD more effectively monitor lenders' performance by developing procedures to identify and prioritize high risk lenders for lender reviews and ensuring that the HOCs consistently apply these procedures.

2) Post-Endorsement Technical Reviews

Desk audits to evaluate the underwriting quality of individual loans already committed to FHA insurance by DE lenders – known as *post-endorsement technical reviews* – are another important lender oversight tool. The large majority of HUD's technical reviews are performed by firms under contract with the HOCs. Technical reviews that reveal deficiencies may result in HUD requiring the lenders to compensate it for financial losses or suspending the lenders' DE authority.

Although all four HOCs met HUD's goal to perform technical reviews of no less than 10% of all loans insured in fiscal year 1999, they generally did not target these reviews towards loans (1) that exhibit high-risk characteristics, or (2) that were made by high-risk lenders, such as those with known performance problems. The HOCs also did not comply with HUD's guidance of subjecting to technical reviews all loans by newly approved DE lenders. As a result, according to GAO, underwriting practices that significantly increase HUD's insurance risk may be going undetected.

One reason for this failure to target risky loans and lenders is that HUD's computer system currently cannot automatically identify and select high risk loans for review. HUD has advised GAO that it is developing a "mortgage scorecard" computer system to be implemented by 2001 which, it believes, will make identification of high-risk loans easier.

Another problem GAO found was with HUD's oversight of the contractors that conduct the bulk of its technical reviews. Each contract contains specific performance standards expressed as the maximum accepted percentage of reviews that can contain significant errors, or omissions. GAO found that three of the four HOCs were not tracking the contractors' work against these standards. Without this information, the HOCs were not in a position to provide the contractors with adequate performance feedback or, if necessary, to enforce the contracts' performance clauses.

GAO recommended that HUD develop procedures and enhance FHA's management information systems to identify and select, for technical reviews, loan and lenders within each HOC's jurisdiction that pose a high insurance risk to HUD. GAO also recommended that HUD comply with guidance to perform technical reviews of all the FHA-insured loans that are made by lenders that possess newly granted DE authority. In addition, GAO recommended that HUD track the performance of contractors conducting technical reviews against performance standards in the contracts, and take appropriate actions against contractors whose performance is not acceptable.

c. Enforcement Actions Against Lenders

To hold lenders accountable for program violations or poor performance, HUD may (1) suspend their DE authority, (2) terminate their loan origination authority through its Credit Watch program, or (3) take enforcement action through its Mortgagee Review Board. Despite the availability of these measures, GAO found that HUD has not taken sufficient steps to hold lenders accountable for poor performance and program violations.

1) Suspension of DE Authority

Although HUD's guidance allows the HOCs to suspend the DE authority of lenders who fail to comply with FHA's underwriting requirements, the HOCs have made limited use of this ability. In fiscal year 1999, for example, the Philadelphia HOC suspended the DE authority of eight lenders; however, the other three HOCs did not take this action against any lenders. Furthermore, HUD's technical review ratings for fiscal year 1999 showed frequent noncompliance by lenders with FHA's requirements, indicating that many other lenders may by candidates for this action. GAO also found that the HOCs had not developed consistent criteria for suspending lenders' DE authority. This proved to be a concern because nearly 20% of the loans subject to technical reviews received "poor" ratings for mortgage credit analysis, meaning that the lenders made mistakes in evaluating the borrowers' credit worthiness that significantly increased HUD's insurance risk. GAO, however, identified 206 lenders that received "poor" ratings for their mortgage credit decisions in more than 30% of the loans that HUD reviewed in fiscal year 1999. On the basis of GAO's analysis, if HUD had reviewed all of the lenders' fiscal year 1999 loans, the percentage of poor ratings could have exceeded 30%. Of the 206 lenders who received poor ratings, 131 made ten or more FHA-insured loans in fiscal year 1999. As of October 1, 1999, HUD's HOCs had not suspended the DE authority of any of the 131 lenders identified by GAO. GAO recommended that HUD strengthen its enforcement efforts by clarifying and implementing guidelines for identifying lenders whose DE authority should be suspended.

2) Credit Watch

As explained above, HUD headquarters implemented its Credit Watch program in May 1999 to terminate the loan origination authority of lenders with excessive defaults and insurance claims on FHA-insured mortgages. Specifically, HUD planned to terminate the loan origination authority of any lender whose default and claim rates on mortgages insured by FHA during the preceding 24 months exceeded both the national average and 300% of the average rate for the HOC serving the lender's geographic location. Similarly, HUD planned to place on "credit watch" status the lenders whose default and claim rates exceeded both the national average and 200% of the corresponding HUD field office average. While on credit watch status, the lender can continue to originate FHA-insured loans, but its performance receives greater scrutiny from HUD. Because the program regulations pertain only to lenders that originated the troubled loans, however, HUD does not always hold accountable the DE lenders that underwrote and approved the loans.

HUD officials recognize that DE lenders contributed to excessive defaults and insurance claims, but that the Credit Watch program limited it from extending the program to DE lenders. They indicated that HUD was considering regulatory changes to solve the problem. The future of Credit Watch, though, is in doubt due to a legal challenge to HUD's authority to implement the program. Among other issues, the lender challenging the program has contended that HUD has exceeded its statutory authority when it issued its Credit Watch regulations and that the manner in which HUD terminated the lender's authority deprived the lender of due process. In October 1999, a United States District Court ruled that the regulations were invalid and set aside HUD's termination of the lender. The case is currently on appeal.

GAO recommended that, once the legal basis for the Credit Watch program is resolved, HUD revise the program's regulations to cover DE lenders that underwrite FHA-insured loans with excessive default and claim rates, as well as those lenders who originate such loans.

3) Mortgagee Review Board

HUD's Mortgagee Review Board can impose administrative actions against FHA lenders that commit program violations. GAO found that the Mortgagee Review Board's process for sanctioning lenders is time consuming. Administrative actions against FHA lenders that commit program violations frequently take more than one year to impose. As a result, some of these lenders continue making FHA-insured loans for one year or more before they are held accountable for past violations. The majority of the Board's actions result in settlement agreements, which require lenders to indemnify improperly originated loans, pay fines, and/or take actions to prevent future lending violations. HUD does not maintain guidelines for the time it should take the Board to take enforcement actions against lenders.

d. Agency Comments

HUD responded that, while it did not always agree with the GAO report's characterization of its practices and procedures for overseeing FHA lenders, it generally agreed with GAO's recommendations. Among HUD's specific objections:

- HUD took issue with GAO's statement that its selection of loans for post-endorsement technical review was not based on risk. HUD maintained that it performs technical reviews of all higher default-rate type loans.
- HUD disagreed with GAO's finding that it was not monitoring the performance of technical review contractors. GAO responded that it did not present such a finding.
- HUD commented that GAO's discussion of technical lender reviews did not adequately recognize that its targeting guidance requires HOC staff to consider several factors in addition to lenders' default and claim rates.
- HUD disagreed with GAO's recommendation that it clarify and implement guidelines for identifying lenders whose DE authority should be suspended, citing that it has threatened suspension in several dozen cases in an attempt to improve lenders' performance.
- Finally, while HUD agreed with GAO's recommendation to revise its Credit Watch program to hold loan underwriters accountable for excessive default and claim rates, it did not believe that it would be appropriate to stop taking enforcement action against loan originators.

2. GAO on HUD's Lack of Appraiser Oversight

The purpose of an FHA appraisal, required for each property it insures, is (1) to determine the property's eligibility for mortgage insurance on the basis of its condition and location, and (2) to estimate the value of the property for mortgage insurance purposes. In performing these tasks, the appraiser is required to identify any visible deficiencies impairing the safety, sanitation, structural soundness, and continued marketability of the property and to assess the property's compliance with FHA's other minimum property standards. According to HUD's guidance, if an appraiser finds noncompliance with these standards, the appraiser should include in the appraisal report an appropriate and specific action to correct the deficiency.

On-site assessments of completed appraisals, known as *field reviews*, are HUD's principal tool for monitoring the performance of the appraisers on FHA's roster. In conducting a field review, a HUD staff person or contractor visits the appraised property to evaluate all aspects of the appraisal, including whether the value determination was reasonable and whether all needed repairs were identified. The field reviewer is required to document his or her findings on a standard HUD form and recommend a score using a scale from 1 to 5 (with 1 being unacceptable and 5 being excellent).

The four HOCs are expected to play important roles in HUD's oversight of the FHA appraisal process. According to HUD, its Real Estate Assessment Center is responsible for analyzing and tracking appraisal quality and appraiser performance, and its Enforcement Center is responsible for sanctioning appraisers, mortgage brokers, and lenders who do not comply with HUD's requirements.

In June 1998, HUD announced a Homebuyer Protection Plan that outlined reforms HUD intended to make to the FHA appraisal process. Specifically, the plan (1) requires that appraisals include a more thorough basic survey of the physical condition of homes; (2) requires lenders to inform potential home buyers of defects found during appraisals; (3) requires appraisers to recommend complete, detailed inspections of homes if the appraisers find significant problems with the properties; (4) allows up to $300 of home inspection costs to be financed through FHA mortgages; and (5) imposes stricter accountability on appraisers and tougher sanctions on those who act improperly, including fines and potential prison sentences. HUD's announcement did not identify a specific timetable for implementing the plan.

Pursuant to a congressional request, GAO reviewed FHA's appraisal process, focusing on (1) how HUD ensures that appraisers on its roster are qualified to perform FHA appraisals; (2) how well HUD is monitoring the performance of the appraisers on its roster and implementing procedures for addressing consumers' complaints about FHA appraisals; (3) the extent to which HUD is holding appraisers accountable for poor-quality FHA appraisals; and (4) the extent to which HUD is holding lenders responsible for the quality of the FHA appraisals they use. On April 16, 1999, GAO presented its findings in a report entitled, "Single-Family Housing: Weaknesses in HUD's Oversight of the FHA Appraisal Process."

a. HUD Has Limited Assurance That Appraisers Are Familiar With FHA's Appraisal Requirements

Only appraisers approved by FHA may evaluate homes for FHA insurance endorsement purposes. To be eligible for FHA's roster of approved appraisers, appraisers must be state licensed or certified in accordance with the minimum criteria established by the Appraiser Qualifications Board of the Appraisal Foundation. The Qualifications Board's minimum licensing criteria require that appraisers have 90 hours of classroom education in subjects related to real estate appraisals, have 2,000 hours of appraisal experience, and pass the Qualifications Board's endorsed examination or an equivalent examination.

Unlike appraisals for conventional mortgages, appraisals for FHA-insured mortgages must include an assessment of the properties' compliance with FHA's property standards as well as appropriate and specific actions to correct conditions not in compliance with these standards. In addition, the value that an appraiser assigns to a property must reflect its value with all the required repairs completed.

HUD relies largely on the states' licensing process to ensure that appraisers are qualified. The states' minimum licensing standards, however, do not include proficiency in FHA's appraisal requirements. In conjunction with its Homebuyer Protection Plan, HUD has developed a new appraisal report, known as the valuation condition report, to record the results of appraisals. The new report lists specific physical conditions for which the appraiser should check, and requires the appraiser to recommend whether a complete home inspection or some other type of inspection (e.g., electrical, roofing, or structural) should be conducted. HUD will require lenders to provide a summary of the appraisal report to home buyers so that they will have information about needed repairs and recommended inspections.

HUD is also in the process of adopting a requirement that appraisers pass a test on FHA appraisal requirements and procedures to be eligible to perform FHA appraisals. HUD delayed implementation of these reforms until March 2000 and, therefore, conclusive data on their effectiveness has not been collected.

b. HUD's Monitoring of Appraisers Is Limited

GAO found that HUD was not doing a good job of monitoring the performance of appraisers, thereby limiting its ability to assess the quality of appraisals used to qualify properties for FHA-insured loans. For example, the Philadelphia and Denver HOCs' records for 126 field reviews that rated appraisals as "poor" showed that HUD approved mortgage insurance for 96 of the homes covered by these reviews. In 37 of the 96 cases, the field reviews were performed after mortgage insurance had been approved.

Specifically, GAO found that weaknesses existed in the scope of field review coverage. In September 1997, HUD established a policy requiring its field offices and their successors, the

HOCs, to field review no less than 10% of the appraisals conducted within their jurisdictions. In fiscal year 1998, HUD performed about 81,000 of these reviews, but three of the four HOCs did not meet the 10% requirement in fiscal year 1998. HUD also did not field review many appraisers with significant workloads. For example, HUD did not field review the work of thousands of appraisers who conducted ten or more FHA appraisals during the period from October 1, 1997, through June 30, 1998. While HUD's procedures do not require field reviews for appraisers doing a higher volume of appraisals, HUD had little assurance that those appraisers were conducting accurate and thorough appraisals in the absence of performance information on these individuals.

Philadelphia and Denver HOC officials told GAO that several factors contributed to problems with field review coverage. These factors included (1) HUD's reliance on contractors to conduct field reviews and the unavailability of contract funds during the first several months of the fiscal year, (2) the reassignment of personnel during HUD's reorganization, which, in some instances, left no one responsible for ordering field reviews; and (3) the lack of emphasis that some field offices placed on field reviews once they knew their functions would be transferred to the HOCs.

GAO also found that many field reviews were not timely. Although HUD's guidance states that timeliness is essential to ensure quality field reviews, half of the field reviews conducted in fiscal year 1998 did not occur until at least 77 days after the appraisals had been performed. In six of HUD's field office jurisdictions, the corresponding figure was 140 days or more. In contrast, HUD reported in fiscal year 1997 that all field reviews were being completed within 45 days of the appraisals. Philadelphia and Denver HOC officials told GAO that the reduced timeliness of field reviews made it difficult to prevent the approval of FHA mortgage insurance for loans based on faulty appraisals and reduced the usefulness of field review reports as a monitoring and enforcement tool.

In addition, GAO found that HUD's oversight of field review contractors was limited. At the Philadelphia and Denver HOCs, HUD staff did not routinely visit appraised properties to verify the observations of field review contractors or systematically evaluate the contractors' performance. Officials at both the Philadelphia and Denver HOCs told GAO that they rarely conducted such evaluations because they lacked sufficient staff and travel resources. As a result, they neither tracked the percentage of each contractor's work that received an on-site review nor evaluated the contractors' performance with a numerical rating system.[166] Because HUD has found it difficult to monitor such a large number of contracts (estimated at 250), it planned to contract out the field review function to a small number of large appraisal firms. It also planned to have HUD staff perform quality assurance reviews of the contractors.

[166] HUD's policy guidance stresses the importance of evaluating the work of field review contractors and states that 5 percent of every contractor's work should be reviewed and rated on scale from 1 to 5 (with 1 being unacceptable and 5 being excellent). The purpose of this rating system is to document performance problems and justify disciplinary actions against field review contractors, if necessary.

Moreover, GAO found that the Philadelphia and Denver HOCs did not fully implement HUD ance on the handling and tracking of consumers' complaints, including those relating to appraisals. In October 1998, HUD officials told GAO that the Philadelphia HOC was developing a set of written procedures for all four HOCs to follow. GAO found that the Philadelphia and Denver HOCs did not have complaint tracking systems that contained all of the information required by the December 1997 policy memorandum. Both HOCs maintained logs showing, among other things, the HOC official assigned to follow up on a complaint and the date the follow-up action was completed. However, these logs did not include other required information, such as the nature of the complaint, the actions taken to address the complaint, or the final disposition of the complaint. This information would enable the HOCs' management readily to determine the frequency of different types of complaints and ensure that all complaints were being resolved in an appropriate manner. These changes were implemented and, according to HUD, have greatly improved the ability of the HOCs to handle complaints.

GAO concluded that these weaknesses in HUD's oversight of the FHA appraisal process have increased FHA's risk of insuring properties that are overvalued or whose owners may default on their FHA-insured loans because of unexpected repair costs. The consequence of this increased risk is higher potential losses to FHA's insurance fund. GAO recommended that HUD achieve better field review coverage of FHA's appraiser roster by (1) ensuring that each HOC reviews the required percentage (currently 10%) of the FHA appraisals conducted annually within its geographic jurisdiction, and (2) requiring that when selecting appraisals for field review, HUD staff give higher priority to the work of appraisers who have done a substantial number of FHA appraisals but have not been field reviewed within the past year. GAO also recommended that HUD make field reviews of appraisals more timely by establishing a process to ensure that HUD staff obtains copies of appraisal reports and perform field reviews prior to FHA's approval of mortgage insurance. In addition, GAO recommended that HUD better assess the quality of appraisal field reviews by insuring that a portion of each field review contractor's work is verified through on-site evaluation of properties reviewed by the contractor.

In commenting on GAO's recommendation that HUD achieve better field review coverage of FHA's appraiser roster, HUD indicated that it would implement a revised field review process by July 1, 1999, that would improve its sampling and targeting of appraisers for field review. In response to GAO's recommendation that HUD conduct on-site evaluations of a portion of each field review contractor's work, HUD indicated that it would begin performing supervisory reviews of contractors in conjunction with a national field review contract scheduled to begin in July 1999. Implementation of both these changes was delayed until March 2000. HUD disagreed with GAO's recommendation to improve the timeliness of appraisal field reviews by obtaining copies of the appraisal reports and performing field reviews prior to loan closings and the approval of FHA mortgage insurance. HUD indicated that the collection of all appraisals and the performance of field reviews before the approval of mortgage insurance would be impractical and inconsistent with HUD's Direct Endorsement Program, which allows qualified mortgagees to process and close FHA loans without prior review by HUD. In turn, GAO modified this recommendation to reflect the fact that it may be difficult for HUD to field review appraisals before the lenders close on the loans.

c. HUD Sanctioned Few Poorly Performing Appraisers

GAO found that HUD was not holding appraisers accountable for the quality of their appraisals. A poor field review score (i.e., a score of 1 or 2 on a scale of 1 to 5) indicates that the appraiser did not adequately support the value assigned to the home, overlooked serious repair conditions, or made other errors and omissions that could result in an unacceptable insurance risk to FHA. A poor field review rating indicates that HUD's HOCs may impose an administrative sanction, called a *limited denial of participation*, that bars an appraiser from participating in FHA programs for up to one year. HUD's policy states that appraisers who receive two or more poor scores in field reviews during any 12-month period should be issued a limited denial of participation temporarily prohibiting them from conducting further FHA appraisals for a period of time determined by FHA.

Contrary to HUD's policy, appraisers who received two or more poor ratings in field reviews were frequently not prohibited from conducting additional FHA appraisals. During the first three quarters of fiscal year 1998, 246 of the 5,768 field reviewed appraisers within the Philadelphia and Denver HOCs' jurisdictions received two or more poor field review scores but, as of October 1, 1998, HUD had issued limited denials of participation to only eleven of those appraisers.

GAO found that poor record-keeping by HUD's field offices was the primary reason for the HOCs' inability to pursue enforcement actions against other poorly performing appraisers. HUD's policy was to sanction appraisers only when there is substantial evidence and documentation of performance that is less than acceptable. Philadelphia and Denver HOC officials told GAO that a lack of supporting documentation had hampered their efforts to sanction appraisers. GAO verified this assertion through its review of appraisers' files at both the Philadelphia and Denver HOCs, which disclosed that most of the field review reports supporting the poor field review scores recorded in HUD's files were missing altogether.

GAO concluded that HUD's ability to sanction poorly performing appraisers was seriously impaired by the loss or misplacement of records prior to and during HUD's field consolidation. Consequently, hundreds of appraisers whose work may be creating an unreasonable underwriting risk for FHA continue to conduct appraisals for FHA-insured mortgages. However, the two HOCs GAO visited have taken steps toward enforcing FHA's performance standards for appraisers.

d. HUD Has Not Aggressively Enforced Its Policy on Lenders' Accountability for Appraisals

HUD's policy is that lenders are responsible, equally with the appraisers they select, for the accuracy and thoroughness of appraisals. In October 1994, HUD issued regulations implementing a legislative provision that allowed lenders to choose the appraisers of properties to be insured by FHA. While the legislation did not address this issue, HUD's regulations stated that lenders who selected their own appraisers were equally responsible, along with the appraisers, for the accuracy, integrity, and thoroughness of the appraisals. In May 1996, HUD repealed these regulations as part of a larger federal effort to reduce the regulatory burden of participating in government programs. According to HUD, the regulations were not necessary because many of the standards in the regulations were already in HUD's handbook guidance and mortgagee letters issued to lenders.

Despite the repeal of these regulations, HUD issued mortgagee letters to lenders in November 1994 and again in May and November of 1997 reiterating its policy that lenders were equally responsible for the quality of appraisals. HUD's Deputy Assistant Secretary also indicated that the failure of a lender voluntarily to resolve the appraisal deficiencies raised by HUD would result in enforcement action against the lender, including probation and suspension.

According to GAO, HUD has not aggressively enforced this policy because of disagreement within HUD over its authority to do so. In May 1998, the Philadelphia HOC requested that HUD's Mortgagee Review Board sanction a lender who refused to correct property deficiencies that the appraiser had overlooked. This was the first case of this type that had been referred to the Board. However, the Board never reviewed or acted on this request because the Board's staff did not believe that HUD had the authority to hold a lender accountable for the quality of an appraisal simply because the lender selected the appraiser. As a result, the HOCs have been reluctant to refer similar cases to the Board. Currently, the matter has still not been resolved.

To improve HUD's oversight of lenders participating in FHA's programs, GAO recommended that HUD (1) determine its authority to hold FHA-approved lenders accountable for poor quality FHA appraisals performed by the appraisers they select from FHA's roster, and (2) issue policy guidance that sets forth the specific circumstances under which HUD may exercise this authority. HUD responded that it would target for monitoring those lenders that used poorly performing appraisers.

B. HUD Office of Inspector General

HUD OIG, led by Inspector General Susan Gaffney, has been vocal in its criticism of HUD's management of the Single Family Mortgage Insurance Program. HUD OIG notes that HUD has undertaken major structural and organizational changes in single family operations over the last five years. These changes include the consolidation of single family field operations into the four HOCs, significant staffing cuts in headquarters and field operations, and the delegation to contractors of major portions of its workload. During this period of change, the single family program has been particularly vulnerable to fraud, waste, and abuse. Fortunately, a high mortgage insurance premium structure, FHA's abandonment of traditional insurance fund mutuality principles, and a very strong economy have enabled FHA to more than meet its capital reserve requirements. However, a future economic downturn could seriously affect the financial well-being of FHA's mortgage insurance fund.[167]

In the last year, through audits, investigations, and its Housing Fraud Initiative,[168] HUD OIG has examined nearly every aspect of the single family program. HUD OIG concludes that its work clearly demonstrates (1) a high incidence of fraud, waste, and abuse in FHA's single family operations, and (2) a clear need for HUD to tighten controls over this multi-billion dollar insurance operations.[169]

In 1999, HUD OIG audited the Loss Mitigation Program. This audit found a growing use of loss mitigation tools by servicing lenders, but a lack of program oversight by HUD staff. Loss mitigation tools are intended to help prevent foreclosures. Yet, while the use of these tools has more than tripled in fiscal year 1999, HUD's foreclosure rates continue to rise. The National Delinquency Survey conducted by the Mortgage Bankers Association shows a 39% rise in FHA foreclosure rates over the last five years, from 1.45% at the end of calendar year 1994 to 2.01% at the end of calendar year 1999. During the same period, MBA data show an increase of about 19% in FHA delinquency rates, from 7.26% to 8.61%. At the same time that FHA inforeclosure and delinquency rates were increasing, conventional foreclosure and delinquency rates have either remained relatively constant or declined.[170]

HUD OIG acknowledges that HUD has developed two measures that may strengthen the FHA program. One is the Homebuyer Protection Plan, which is designed to protect borrowers from bad appraisals. The other is the Credit Watch program, which terminates lenders with excessive default rates from FHA programs. Both plans, however, are in their infancy, and thus

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[167] Office of Inspector Gen., U.S. Dep't of Hous. and Urban Dev., Semiannual Report to the Congress 2 (Oct. 1, 1999-Mar. 31, 2000).

[168] HUD OIG's Housing Fraud Initiative ("HFI") is "a proactive law enforcement effort using a unified approach to the detection and prosecution of fraud in HUD programs." Id. HFI combines HUD OIG audit and investigative resources with the investigative and prosecutive skills of the Federal Bureau of Investigation and United States Attorney's Offices in designated federal judicial districts to root out fraud in all HUD funded activities. HFI was the result of concern by members of the House Appropriations Subcommittee on VA, HUD, and Independent Agencies that HUD funds may not be reaching those needing federal assistance due to pervasive fraud. HFI began in October 1998 with the designation of six federal judicial districts to serve as initial HFI sites. Id.

[169] Id.

[170] Id.

thorough evaluation is not possible. The Homebuyer Protection Plan is making strides to improve the quality of appraisals, yet the enforcement aspect of the plan is still not fully developed. Also, the Credit Watch Program will take action only against those lenders with the most egregious default record. Very few actions have been taken to date, and two actions terminating lenders have culminated in successful legal challenges by the lenders. Moreover, neither of these initiative substitutes the need for HUD staff to better monitor lender performance.[171]

HUD OIG's audit and investigative work have disclosed that HUD's current procedures for monitoring lenders and oversight of contractors are less than effective. In HUD OIG's view, this lack of oversight clearly contributes to fraud and abuse of the FHA Single Family Program. This is because FHA's mortgage insurance risk depends almost exclusively on the reliability of work performed by its DE lenders, who underwrite nearly all FHA insurance. FHA mitigates its risk through lender oversight. Three important HUD monitoring tools should be working to prevent the insurance of fraudulent loans are post endorsement technical reviews of loan underwriting documentation, field reviews of appraisals, and quality assurance reviews of lenders. When used effectively, these tools can highlight problem loans or lenders. HUD OIG has found, however, that HUD's monitoring was not focused on lender and appraiser high risk indicators. Rather, HUD's focus was on meeting numerical review goals as set forth in its Business and Operating Plan.[172]

1. Post Endorsement Technical Reviews

Post-endorsement technical reviews of underwriting and property appraisals are key controls in monitoring DE lenders. These technical reviews typically consist of a desk review of FHA case documentation after insurance endorsement to assess lender compliance with HUD underwriting and appraisal requirements. HUD has retained contractors to perform most of this work at a price ranging from $15 to $35 per case.[173] If the technical review discloses an improper endorsement or other problems, then HUD staff is to take such remedial actions as seeking indemnification from lenders for loans not meeting FHA endorsement criteria, or referring lenders to the Quality Assurance Division for on-site review.[174]

HUD OIG found that HUD over-relied on the work of these contractors and was not reviewing contractor performance. The effects of such over-reliance were demonstrated in a

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[171] Id.

[172] Id. at 4.

[173] Id.

[174] Office of Inspector Gen., U.S. Dep't of Hous. and Urban Dev., Audit Report 00-SF-121-0001, Single Family Production Home Ownership Centers 7 (Mar. 30, 2000).

recent case in which Allstate Mortgage Company fraudulently originated over 400 FHA loans totaling $97 million. Seventeen of these loans had undergone post-endorsement reviews by a contractor. The contractor found no significant problems with these loans, even thought the loan files showed obvious fraud indicators. None of the seventeen cases had been re-examined by HUD contract monitors.[175]

HUD OIG's reexamination of 151 post-endorsement reviews found that seventy reviews failed to disclose material underwriting errors. Thirty-two reviews failed to identify significant fraud indicia.[176] HUD OIG's review found several reasons why HUD's controls over the post-endorsement technical review process were not providing meaningful results. These included inexperienced staff in critical HUD control positions, increased loan volume with fewer staff to monitor lenders, no clear operating policies or procedures for HOC operations, outdated handbooks, emphasis on quantitative goals, and financial disincentives for contractors to find problem endorsements. Even when significant technical review problems were noted, HUD implemented few, if any, corrective actions.[177]

2. Post-Endorsement Field Reviews of Appraisals

Another critical control feature is the systematic testing of property appraisals by HUD. The DE lender selects the appraiser that sets the value of the property for FHA insurance. With the high loan to value ratio of most FHA loans, an accurate appraisal is critical to minimizing HUD's insurance risk. HUD's procedures call for field reviews of 10% of all appraisals,[178] and 5% of each appraiser's work.[179] In addition, all appraisers receiving a "poor" rating during the post-endorsement technical review process are to be subject to field review.[180] However, HUD OIG found that the HOCs did not have a systematic procedure for selecting appraisals for review to ensure that the required 5% of each appraiser's work was reviewed. This is because the HOCs did not have contracts for field review of appraisals in all areas of their jurisdictions. Moreover, lenders did not always provide a required second copy of the appraisal, or the appraisal report was incomplete, and the HOCs accepted the cases instead of rejecting them. In addition, the

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[175] Office of Inspector Gen., U.S. Dep't of Hous. and Urban Dev., Semiannual Report to the Congress 4 (Oct. 1, 1999-Mar. 31, 2000).

[176] Id. at 32.

[177] Id. at 4.

[178] Id. at 5.

[179] Office of Inspector Gen., U.S. Dep't of Hous. and Urban Dev., Audit Report 00-SF-121-0001, Single Family Production Home Ownership Centers 38 (Mar. 30, 2000).

[180] Id.

HOCs' primary emphasis was on meeting their goal of completing field reviews of 10% of the total appraisals instead of ensuring the program was working properly.[181]

Even when field reviews disclosed problems with appraisers, HUD failed to use the results to take action. Branch chiefs at three of the four HOCs told HUD OIG that they did not have enough staff to monitor appraisers or to sanction poor performers. As a result, HUD lacks assurance about the quality of appraisals supporting loans processed and approved by lenders.[182] HUD's lack of action on poor appraisers is evident from its own numbers. According to HUD's Single Family Data Warehouse information system, during the two-year period ending September 30, 1999, 15,526 appraisals received "poor" desk review ratings. However, 13,007, or 83.8%, of these appraisals were not subjected to field review.[183] Instead, these poor ratings were entered into CHUMS without any subsequent action.[184]

3. Quality Assurance Reviews

A third important control over DE lender activity is on-site monitoring reviews. These reviews, which are conducted by the HOCs' Quality Assurance Divisions ("QADs"), are intended to identify and correct poor origination practices. After completion, the QADs communicate the review results to lenders and request written responses. Lenders are asked to explain the problems noted, list actions taken to prevent future problems, and/or agree to indemnify HUD for possible losses associated with improperly originated loans. While the QADs should focus on lenders with high defaults and foreclosures, the QADs instead reviewed many low risk lenders in order to meet their numeric review goals. Even when the QADs identified deficiencies during on-site reviews, they did not follow-up when lenders failed to respond to the QADs' findings and recommendations.[185]

In addition to these findings, HUD OIG determined that the Approval/Recertification/ Review Tracking System ("AARTS") HUD uses to track the status and results of QAD reviews

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[181] Id. at 39.

[182] Office of Inspector Gen., U.S. Dep't of Hous. and Urban Dev., Semiannual Report to the Congress 5 (Oct. 1, 1999-Mar. 31, 2000).

[183] Office of Inspector Gen., U.S. Dep't of Hous. and Urban Dev., Audit Report 00-SF-121-0001, Single Family Production Home Ownership Centers 42 (Mar. 30, 2000).

[184] Id. at 43.

[185] Office of Inspector Gen., U.S. Dep't of Hous. and Urban Dev., Semiannual Report to the Congress 5 (Oct. 1, 1999-Mar. 31, 2000).

contained significant errors, and therefore did not provide sufficient accountability for audit and staff evaluation purposes.[186]

VI. Conclusion

This memorandum illustrates the two objectives of our hearing: (1) To show that flipping is a nationwide phenomenon that has had a detrimental impact on families and neighborhoods, and (2) to show that HUD's lack of meaningful oversight has contributed to this growing problem. Although HUD has taken steps to curb fraud involving FHA-backed mortgages, it must answer for its past mismanagement that has exacerbated the flipping crisis and rendered its most recent task forces and programs necessary.

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[186] Id. at 32-33.

Senate Permanent Subcommittee
On Investigations

EXHIBIT # 15

**New York City Lending Activities**
**Actions Taken**

The Department is aware of allegations of misuse of HUD/FHA programs that have been the subject of recent media coverage. We take these allegations seriously and are actively working with the US Attorney and the local District Attorney offices, the FBI and our OIG to take appropriate actions against those identified by the media as well as others.

Meanwhile, we are aggressively pursuing this matter. HUD/FHA has taken or recommended many actions on more than 100 organizations and persons as a result of its reviews. Over the past 15 months, we have taken one or more of the following actions against:

Lenders
- referred 11 lenders to the Mortgagee Review Board for possible sanctions
- referred 7 lenders to the MRB which are pending
- withdrawn the FHA approval of 4 lenders plus 2 others for 3-5 years[1]
- temporarily terminated 2 lenders' ability to originate loans under our Credit Watch Initiative, and have proposed the termination of 1 more
- 8 lenders were issued warning letters concerning their relative high default/claim rates (Credit Watch status)
- 3 are lenders currently under investigation by other Federal and/or state organizations
- referred 7 lenders to the OIG for further investigations
- suspended the Direct Endorsement Authority of 10 lenders; 2 have been released
- placed 9 lenders on 100% Post Technical Review Status to ensure the quality of their underwriting
- entered into 6 settlement agreements with lenders plus one is pending
- reviewed or are currently reviewing a total of 35 lenders

Non-profits
- removed or suspended 74 non-profits from participating in all or a portion of our programs
- referred 2 non-profits for investigations
- initiated new systems for re-certifying non-profits every two years

Individuals and other entities
- 4 appraisers, one appraisal company and a certified inspector were issued Limited Denial of Participation
- 19 have been referred for suspensions/debarments
- 10 individuals and companies have been referred for further investigation

As we continue our review, HUD expects to take additional administrative sanctions against individuals and companies, as well as actions against non-compliant lenders. Such actions can range from a reprimand to the withdrawal of a lender's FHA-approval. Civil Money Penalties may also be assessed, up $5,500 per violation[2].

[1] The Board withdrew FHA-approval of two other lenders in the area for 203(k) violations in 1996 & 1997.
[2] The Department issued an interim rule on 2/23/00 which will allow it to assess CMPs to other participants in Housing programs such as, Realtors, inspectors, appraisers, etc.

# NEW YORK CASES

## Actions Taken

**Lenders reviewed in last 15 months or currently under review**

| | |
|---|---|
| Madison Home Equities | Budget Mortgage |
| Alliance Mortgage Banking Corp | City National Mtg. |
| Professional Mortgage Bankers Corp | National City Mtg. |
| Saxon Equities Corp | 1st National Funding |
| Ideal Mortgage Bankers | Stagg Mtg. |
| Mortgage Lending of America (MLA) | Waterfield Financial |
| Mortgage Money Center | Federal Standard Mtg. |
| Community Home Mortgage Corp | Continental Mtg. |
| Brucha Mortgage Bankers Corp | Cross Island Capital |
| Island Mortgage Network | American Home Mtg. |
| Ryan's Express Equities Corp | Consumer Home Mtg. |
| Sommerset | Len-Mor Capital |
| First Republic Bank | Astoria Federal |
| Hanover Mortgage | Tam Equity |
| Continental Capital | Interamerican Mortgage |
| First Funding Mortgage | Columbia Equities, LTD |
| Mutual of North America | Mortgage Enterprise |
| Golden National Mortgage | |

| **Referrals to the Mortgagee Review Board- last 12 months** | Hearing Scheduled |
|---|---|
| Greystone Servicing Corporation, Inc. | October 21, 1999 |
| Community Home Mortgage Corp | March 13, 2000 |
| Madison Home Equities | April 20, 2000 |
| Bank of New York | April 20, 2000 |
| Island Mortgage Network | April 20, 2000 |
| Mortgage Lending of American (MLA) | July 6, 2000 |
| Hanover Capital Mortgage, Inc. | July 6, 2000 |
| Ryan's Express Equities Corp | Pending |
| Alliance Mortgage Banking Corp | Pending |
| Somerset Investors Corp | Pending |
| First Republic Mortgage Bankers | Pending |

| **Referrals to the MRB - pending** | |
|---|---|
| Brucha Mortgage Bankers Corp | Pending |
| Ideal Mortgage Bankers | Pending |
| Budget Mortgage | Pending |
| American Home Mtg. | Pending |
| Consumer Home Mtg. | Pending |
| Lend-More Mortgage Bankers | Pending |
| First Funding Mortgage | Pending |

| **Lenders withdrawn** | Date |
|---|---|
| Amerifirst Mortgage Corp | 1999 |
| Mortgage Acceptance Corp | 1999 |
| Kadilac Mortgage Bankers, Ltd | 1996 |
| Eastwood Mortgage Bankers | 1997 |
| Madison Home Equities * | 2000 |
| Island Mortgage Network** | 2000 |

* Madison Home Equities was fined $71,500 and their FHA Approval was pulled for five years.
**Island Mortgage Network was fined $66,000 and their FHA Approval in the Buffalo/Albany are was pulled for three years.

**Lenders referred for further investigation (OIG)**

Madison Home Equities
Mortgage Money Center
Mortgage Lending of America (MLA)
Community Home Mortgage Corp
Brucha Mortgage
Ryan's Express
Cross-Island Capital

| **HUD has entered into Settlement Agreements** | Date |
|---|---|
| Professional Mortgage Bankers Corp | 1999 |
| Madison Home Equities | 1998 |
| Consumer Home Mortgage, Inc. | 1997 |
| Continental Capital | 1997 |
| Saxon Equities Corp | 1992 |
| Mortgage Money Center | 1999 |
| Community Home Mortgage, Inc | Pending |

**Lenders terminated through Credit Watch/Termination**

Mortgage Lending of America
Mortgage Acceptance Corporation (filed bankruptcy in Calif)
Somerset Investors Corp - proposed termination - Round 4

**Lenders placed on Credit Watch**

Cross Island Capital Corp
Ideal Mortgage Bankers
Alliance Mortgage Bankers
Interamerican Mortgage
Columbia Equities LTD
First Funding Mortgage
Premier Mortgage Corporation

Saxon Equities Corp

**Lenders placed on 100% Post Endorsement Technical Review status**

American Home Mortgage (released 1/22/00)
Madison Home Equities
Columbia Equities
Mortgage Money Center (released 1/13/00)
Wall Street Mortgage Bankers
Budget Mortgage Bankers
Somerset Investors
Ryan's Express
First Funding

**Lenders returned to Pre-Closing Review status**

Community Home Mortgage (203k only)
Mortgage Lending of America (203k only)
Madison Home Equities (released 1/25/00)
American Home Mortgage (released 1/22/00)
Premier Mortgage
Main Street Mortgage
Home Funding Finders
Executive Mortgage
Brucha Mortgage
Smith haven Mortgage

**Non-Profits removed/suspended**

| | |
|---|---|
| Two or Three Gathered Together | Brooklyn, NY |
| Advance Local Development Corporation | Brooklyn, NY |
| Bread of Life Fellowship, Inc. | North Babylon, NY |
| Church Planting and World Ministry Outlook | Freeport, NY |
| Dominion Church of God's Grace Dominionites, Inc. | Brooklyn, NY |
| Gospel Tabernacle of Jesus Christ Apostolic, Inc. | Brooklyn, NY |
| H.O.G.A.R. | Haverstraw, NY |
| Habitat for Elderly and Handicapped | Patchogue, NY |
| Helpline Soul Rescue Ministry | Baldwin, NY |
| Vanguard Community Center, Inc. | New York, NY |
| Victory Housing Development Fund, Inc. | E. Patchogue, NY |
| Word of Life Misistries (1 of 2) | Freeport, NY |
| Agape Tabernacle Ministries | Brooklyn, NY |
| Carroll Gardens Assoc, Inc. | Brooklyn, NY |
| Christian Crossroads, Inc. | Brooklyn, NY |
| Citadel of Praise and Worship Ministries, Inc. | Brooklyn, NY |
| Crossover Baptist Church | Brooklyn, NY |
| Eben-Ezer Seventh Day Adventist French Church | Brooklyn, NY |
| God's Battalion of Prayer Church, Inc. | Brooklyn, NY |

| | |
|---|---|
| Guiding Light Pentacostal Assemblies, Inc | Brooklyn, NY |
| Hiddekel Church of God, Inc. | Brooklyn, NY |
| Ingersoll Tenant Assoc., Inc. | Brooklyn, NY |
| Interdenominational Brotherhood, Inc. | Brooklyn, NY |
| Mt. Zion Pentecostal Holiness Church, Inc. | Brooklyn, NY |
| Nehemia Economic Dev. Inc. | Brooklyn, NY |
| Neighbors Helping Neighbors, Inc. | Brooklyn, NY |
| N. Brooklyn Dev. Corp. | Brooklyn, NY |
| Oceanhill-Brownsville Tenants Assoc. Inc. | Brooklyn, NY |
| Bridges to Independence, Inc | New York, NY |
| Calvary Christian Fellowship | New York, NY |
| Church on the Hill - AME Zion | New York, NY |
| Consortium for Central Harlem Dev. | New York, NY |
| Ecumenical Community Dev. Org. | New York, NY |
| H.E.L.P. Equity Homes, Inc. | New York, NY |
| Harlem Congregations for Community Improvement | New York, NY |
| Harlem Restoration Project | New York, NY |
| Homilies Inc | New York, NY |
| Mt. Pisgah Pentecostal Church | New York, NY |
| New York City Black United Fund | New York, NY |
| Partnership Ministries Unlimited | New York, NY |
| Threshold Dev. Corp. | New York, NY |
| Vanguard Community Center, Inc | New York, NY |
| A New Beginning, Inc | Brooklyn, NY |
| A.f.t.e.r. Care Unlimited | Brooklyn, NY |
| BEC Garvey, Inc. | Brooklyn, NY |
| Beulah Cjurch of God in Christ Jesus | Brooklyn, NY |
| Bridges to Independence | New York, NY |
| Calvary Christian Fellowship | New York, NY |
| Charity Temple Church of God | Freeport, NY |
| Christian Life Center | Brooklyn, NY |
| Church on the Hill - AME Zion | New York, NY |
| Congregation Tzorchei Amecha, Inc | Brooklyn, NY |
| Consortium for Central Harlem Dev | New York, NY |
| East New York Urban Youth Corps | Brooklyn, NY |
| Ecumenical Community Dev. Org | New York, NY |
| Freeport Full Gospel Assembly | Freeport, NY |
| Gospel Tabernacle of Jesus Christ Apostolic | Brooklyn, NY |
| H.E.L.P. Equity Homes, Inc | New York, NY |
| Harlem Congregations for Community Imp. | New York, NY |
| Harlem Restoration Project Inc | New York, NY |
| Hiddekel Church of God | Brooklyn, NY |
| Highways and Hedges Church of God in Christ | Brooklyn, NY |
| Homilies, Inc | New York, NY |
| House of Hope | Brooklyn, NY |

| | |
|---|---|
| Housing and Land Dev. Committee Corp | Brooklyn, NY |
| Institutional Church of God in Christ, Inc | Brooklyn, NY |
| Long Island Council of Churches | Baldwin, NY |
| Mt. Pisgah Pentecostal Church | New York, NY |
| New York City Black United Fund | New York, NY |
| Partnership Ministries Unlimited | New York, NY |
| Rock of Holiness Deliverance Faith Ministry | Brooklyn, NY |
| Threshold Dev. Corp | New York, NY |
| Village of Patchogue | Patchogue, NY |
| Word of Life Ministries (1of 2) | Freeport, NY |

**Non-Profits rejected for cause**

| | |
|---|---|
| East Fulton Street Group (under investigation by OIG) | Brooklyn, NY |

**Non-Profits currently under investigation for removal**

| | |
|---|---|
| The Family Preservation Center | Bohemia, NY |
| Alpha and Omega | Brooklyn, NY |

**Individuals referred for Debarment**

Nadine Malone- proposed debarment terminated 7/9/98
P. Yeager
S. Kameika
Beatrice Sukhdeo - currently debarred from 9/30/97 to 9/29/00
Michael Lucey
M. Farley
R. Paoli
J. Coppolla
R. Hochman - pending
Harvey George - pending
M. Fox
Ginnie Phillips - pending
Robert Honan - pending
R. Scorbera - pending
D. Fasio - pending
G. Constantin - pending
Don Fazio - pending
Gary Konstantin - pending
Richard Schlesinger
Nikolasos Beis
Theresa Springer
Deborah Lipscomb
Edward Rodriguez
Steven Katz

Leon Mochkin
Elimelech Naiman
Dharamdeo Kumar
Samuel Weissmandl
Yoel Movtady
Frank Lagrua
Chaim Fischman
David Flaim
David Brown
Bruce Braithwaite
Donald Barron
Jay Bloom
Larry Bennett
Paul Chernick
Kenneth Ashley
Peter Hoffman

**Individuals Receiving Limited Denial of Participation (LDP)**
Chris Liano - principal of CLA, Inc.
Robert Carlsen - FHA certified inspector
John Girvan - appraiser
Ronald Santa - appraiser
Mona Cafaro - pending
Judy Baggio - pending

**Individuals referred for further investigation (OIG)**
Eric Fessler - not a realtor - an investor - associated with Better Homes Depot
Nadine Malone- president of Madison Home Equities
Beatrice Sukhdeo - (uses serveral aliases) former loan officer with Olympic Home Mtge.
Chris Liano- principal of CLA, Inc.
Don Fazio - loan officer, Budget Mortgage - pending
Gary Konstantin - loan officer, Budget Mortgage - pending

**Other Entities referred for further investigation (OIG)**
CLA, Inc. - appraisal company -
Better Homes Depot - Eric Fessler - not a realtor- an investor
Tri Metro Realty - Beatrice Sukhdeo
First Home Brokerage - Jay Gottlieb

**Chicago Lending Activities**
**Actions Taken**

The Department is aware of allegations of misuse of HUD/FHA programs that have been the subject of recent media coverage. We take these allegations seriously and are actively working with the US Attorney and the local District Attorney offices, the FBI and our OIG to take appropriate actions against those identified by the media as well as others.

Meanwhile, we are aggressively pursuing this matter. HUD/FHA has taken or recommended many actions on more than 100 organizations and persons as a result of its reviews. Over the past 15 months, we have taken one or more of the following actions against:

Lenders
- referred 2 lenders to the Mortgagee Review Board for possible sanctions, 2 more are pending
- temporarily terminated 3 lenders' ability to originate loans under our Credit Watch Initiative
- 4 lenders were issued warning letters concerning their relative high default/claim rates (Credit Watch status)
- suspended the Direct Endorsement Authority of **??** lenders
- placed **?** lenders on 100% Post Technical Review Status to ensure the quality of their underwriting
- entered into settlement agreements with 14 lenders
- reviewed or are currently reviewing a total of 45 lenders

Non-profits
- removed or suspended **??** non-profits from participating in all or a portion of our programs
- referred **??** non-profits for investigations
- initiated new systems for re-certifying non-profits every two years

Individuals and other entities
- **??** appraisers, one appraisal company and a certified inspector were issued Limited Denial of Participation
- 2 have been referred for suspensions/debarments
- **??** individuals and companies have been referred for further investigation

As we continue our review, HUD expects to take additional administrative sanctions against individuals and companies, as well as actions against non-compliant lenders. Such actions can range from a reprimand to the withdrawal of a lender's FHA-approval. Civil Money Penalties may also be assessed, up $5,500 per violation[1].

[1] The Department issued an interim rule on 2/23/00 which will allow it to assess CMPs to other participants in Housing programs such as, Realtors, inspectors, appraisers, etc.

# CHICAGO CASES

## Actions Taken

**Lenders reviewed in last 15 months or currently under review**

1. American Dream Home Mortgage
2. American Security Mortgage
3. Banc Group Mortgage Corp
4. Berkshire Mortgage Corporation
5. Carlton Mortgage Services Inc
6. Castle Mortgage Inc
7. Ccs Mortgage Inc
8. Challenge Mortgage Corporation
9. Chase Manhattan Mortgage Corp
10. Chicago Bancorp Inc
11. Cole Taylor Bank
12. Columbia National Incorporated
13. Contour Mortgage Group
14. Countrywide Home Loans
15. Covenant Mortgage Corp
16. Crown Mortgage Company
17. Ctx Mortgage Company
18. Draper And Kramer Mortgage Corp
19. Embassy Mortgage Corp
20. Executive Financial Corp
21. Fair Home Mortgage Co Inc
22. Family First Mortgage Inc
23. First Home Mortgage Corp
24. First Midwest Mortgage Corp
25. Global Mortgage Company
26. Gmac Mortgage Corporation
27. Greater Chicago Mortgage Corp
28. Home Funding Of Chicago Inc
29. Homestart Mortgage Corp
30. Irwin Mortgage Corporation
31. Lincoln Mortgage Funding Corporation
32. Market Street Mortgage Corporation
33. Midwest Funding Corp
34. Mortgage Lending Corporation
35. Mortgage Lending Of America Inc
36. National City Mortgage Co
37. National City Mortgage Services Co.
38. North American Mortgage Company
39. Olympic Mortgage Inc
40. Platinum Home Mortgage Corp
41. Preferred Mortgage Associates
42. Primera Mortgage Company - Il
43. Pulte Mortgage Corp.
44. Realty Funding Corp
45. United Financial Mortgage Corp

| **Referrals to the Mortgagee Review Board- last 12 months** | Hearing Scheduled |
|---|---|
| 1. Greater Chicago Mortgage Corp | January 2000 |
| 2. Banc Group Mortgage Co. | |

**Referrals to the MRB - pending**

1. Executive Financial
2. Anchor Mortgage

**Lenders withdrawn**

None

**Lenders referred for further investigation (OIG)**

None

**HUD has entered into Settlement Agreements**

1. Advance Financial Services
2. Amaris Mortgage Co.
3. Amaris Mortgage Co.

4. Bank of Illinois
5. City Mortgage, Inc.
6. Cole Taylor Bank
7. Creative Mortgage
8. Embassy Mortgage
9. First Midwest Mortgage
10. First Mortgage Corp.
11. Guaranteed Financial
12. Legend Mortgage Company
13. Preferred Mortgage
14. Prism Mortgage Co.

**Lenders placed on Credit Watch Termination**

1. Challenge Mortgage Corporation (termination)
2. Wells Fargo Home Mortgage (termination)
3. Embassy Mortgage Corporation (termination)

1. City Mortgage (credit watch)
2. Creative Mortgage Financial (credit watch)
3. Anchor Mortgage Corporation (credit watch)
4. MCA Mortgage Corporation (credit watch)

**Lenders placed on 100% Post Endorsement Technical Review status**

**Lenders returned to Pre-Closing Review status**

**Non-Profits removed/suspended**

**Non-Profits rejected for cause**

**Non-Profits currently under investigation for removal**

**Individuals referred for Debarment**

1. James Lyall
2. Lisa Grubesic

**Individuals Receiving Limited Denial of Participation (LDP)**

Atlanta needs to provide this

**Individuals referred for further investigation (OIG)**

1. Robert Olson, Jr. - Senior Income Reverse Mortgage Corp.
2. Harvey Jack Waller - Senior Income Reverse Mortgage Corp.
3. Mahar Karamon - Challenge Mortgage Corp.
4. Saber Sabbah - Challenge Mortgage Corp.
5. Efrain Duenas - Challenge Mortgage Corp.
6. Raymundo Torres - Challenge Mortgage Corp.
7. Craig Hendricks - Challenge Mortgage Corp.
8. John Chonis - Challenge Mortgage Corp.
9. Andrew Bronen - Challenge Mortgage Corp.

10. Willie Landfair - Challenge Mortgage Corp.
11. Leo Lopez - Crossland Mortgage Corp.
12. John Jarosezurski - American Security Mortgage
13. Nicole T. (Marie) Hill - American Security Mortgage
14. Al Basano - Anchor Mortgage Corp.
15. Tom Barnes - Anchor Mortgage Corp.
16. Gary Zandonetti - Anchor Mortgage Corp.
17. Gordon Nelson d/b/a Century Homes
18. Doris Watts - Family First Mortgage, Inc.
19. Derrona Diggins - Family First Mortgage, Inc.
20. Josie Diggins - Family First Mortgage, Inc.
21. Bonita Williams - Family First Mortgage, Inc.
22. Linda Coleman - Family First Mortgage, Inc.

**Other Entities referred for further investigation (OIG)**

1. Realities Supportive Services (Non-Profit)

**Florida Lending Activities**
**Actions Taken**

The Department is aware of allegations of misuse of HUD/FHA programs that have been the subject of recent media coverage. We take these allegations seriously and are actively working with the US Attorney and the local District Attorney offices, the FBI and our OIG to take appropriate actions against those identified by the media as well as others.

Meanwhile, we are aggressively pursuing this matter. HUD/FHA has taken or recommended many actions on more than 100 organizations and persons as a result of its reviews. Over the past 15 months, we have taken one or more of the following actions against:

Lenders

- referred 11 lenders to the Mortgagee Review Board for possible sanctions, 8 more are pending
- withdrawn the FHA approval of 1 lender
- temporarily terminated 8 lenders' ability to originate loans under our Credit Watch Initiative, and have proposed the termination of 1 more
- 8 lenders were issued warning letters concerning their relative high default/claim rates (Credit Watch status)
- 2 lenders have been to the OIG for further investigations
- suspended the Direct Endorsement Authority of **??** lenders
- placed **??** lenders on 100% Post Technical Review Status to ensure the quality of their underwriting
- entered into settlement agreements with 17 lenders
- reviewed or are currently reviewing a total of 89 lenders

Non-profits

- removed or suspended **??** non-profits from participating in all or a portion of our programs
- referred 2 non-profits for investigations
- initiated new systems for re-certifying non-profits every two years

Individuals and other entities

- **??** appraisers, one appraisal company and a certified inspector were issued Limited Denial of Participation
- 17 have been referred for suspensions/debarments
- 62 individuals and companies have been referred for further investigation

As we continue our review, HUD expects to take additional administrative sanctions against individuals and companies, as well as actions against non-compliant lenders. Such actions can range from a reprimand to the withdrawal of a lender's FHA-approval. Civil Money Penalties may also be assessed, up $5,500 per violation[1].

[1] The Department issued an interim rule on 2/23/00 which will allow it to assess CMPs to other participants in Housing programs such as, Realtors, inspectors, appraisers, etc.

**Lenders reviewed in last 15 months or currently under review**

1. All Professional Lending Corp
2. Allied Mortgage Capital Corp
3. American Mortgage Capital Inc
4. American Mortgage Co And Assoc Inc
5. American Skycorp Inc
6. American Trust Mortgage Brokers
7. Amerisfirst Mortgage And Inv Inc
8. Amsouth Bank
9. Approved Home Mortgage Corporation
10. Approved Mortgage
11. Arbor Lending Corp
12. Atlantic Pacific Mortgage Corp
13. Banc Plus HomeAmerican Mortgage Link I
14. Mortgage Center, Inc
15. Bankers Choice Mortgage Corp
16. Bankers Mortgage Trust Inc
17. Bridge Mortgage Bank Of America Inc
18. Capital City Bank
19. Capitol Mortgage Bankers Inc
20. Charter One Mortgage Corp
21. Chase Manhattan Mortgage Corp
22. Citizen Trust Mortgage Corp
23. Cmal Inc
24. Community National Mtg Corp
25. Contemporary Mortgage Services Inc
26. Continental Home Funding Corp
27. Continental Trust Mtg Corp
28. Country Home Mortgage
29. Countrywide Funding Corp.
30. Ctx Mortgage Co
31. Cypress Financial Mortgage Corp Inc
32. Diversified Home Mortgage Inc
33. Dolphin Mortgage Co
34. Dunne And Company Mortgage Lenders
35. Equity Financial Group
36. Executive Funding Corporation
37. Ffs Mortgage Corp
38. Financial Funding Services
39. First Financial Of Boston
40. First Preference Mtg Corp
41. First South Bank (Br2)
42. Floridas Best Mortgage Corp
43. Foundation Funding Group Inc
44. Freel And Stringer
45. Ft Mortgage Companies
46. GHI Corporation
47. GMAC Mortgage Corporation
48. Green Apple International Assets Inc
49. Home Mortgage Funding
50. Homeside Lending
51. IDL Mortgage Corporation
52. Interamerican First Mortgage Corp
53. Liberty Mortgage Finance Service
54. Market Street Mortgage Corporation
55. MFC Mortgage Inc Of Florida
56. Mission Mortgage Corporation
57. Mortgage-Com Inc
58. Mortgage Funding Group Inc
59. Mortgage Investors Of Orlando Corp
60. Mortgage Professionals Inc
61. Mortgage Solutions Of Central Fl Inc
62. Mortgage One Financial Services Corp
63. Nationsbanc Mortgage Corp
64. New South Federal Savings Bank
65. North American Mortgage Company
66. Norwest Mortgage
67. NVR Mortgage Finance Inc
68. Pace Financial Corporation
69. Paradigm Mortgage Associates Inc
70. Peninsula Mortgage Bankers
71. Pjp Enterprises Inc
72. Prestar Mortgage Corporation
73. Republic Bank
74. Ryland Mortgage Co
75. Ryland Mortgage Company
76. Safeway Mortgage And Investment Co Inc
77. Southern Mortgage Investment Corp
78. Southern Styles Mortgage Corp
79. Southshore Mortgage Company
80. Specialty Mortgage Corp
81. Spectrum International Mortgage Service
82. Sunshine Mortgage Services Inc
83. Tab Mortgage
84. Town And Country Mortgage Serv
85. Tucker Federal Savings And Loan Assoc
86. Home Mortgage
87. Unifirst Mortgage Corporation
88. Union Bancshares Mortgage Corp
89. Wells Fargo Home Mortgage, Inc

| **Referrals to the Mortgagee Review Board- last 12 months** | Hearing Scheduled |
|---|---|
| 1. Republic Bank dba Capital Mortgage | Pending |
| 2. Homeside Lending, Inc. | January 7, 2000 |
| 3. North American Mortgage Corp (T&N Mortgage) | Pending |
| 4. FFS Mortgage Corp | Pending |
| 5. Cypress Financial Mortgage Corp | Pending |
| 6. First Financial of Boston | Pending |
| 7. BancGroup Mortgage Corporation | Pending |
| 8. Financial Funding Services, Inc. | July 6, 2000 |
| 9. Approved Home Mortgage Corp | Pending |
| 10. Ocwen Financial Corp | Pending |
| 11. Southern Mortgage | Pending |

**Referrals to the MRB - pending**

1. American Mortgage
2. American Mortgage Link
3. Bankers Choice Mortgage
4. Crestar Mortgage
5. GHI Corporation
6. MortgageOne Financial
7. Mortgage Professionals, Inc.
8. Professional American Mortgage

| **Lenders withdrawn** | Date |
|---|---|
| 1. J P Mortgage | 1999 |

**HUD has entered into Settlement Agreements**

1. Allied Mortgage
2. American Mortgage
3. Bell Financial Group
4. CharterOne Mortgage
5. Chase Manhattan Mortgage
6. Countrywide Home
7. Dow Guarantee Corp.
8. Executive Funding
9. GHI Corp.
10. Homeside Lending, Inc.
11. NationsBanc Mortgage
12. Nationwide Mortgage
13. North American Mortgage
14. Norwest Mortgage
15. Paramount Financial
16. Southshore Mortgage
17. Tucker Federal Savings

**Lenders placed on Credit Watch Termination**

1. Florida Capital Mortgage (termination)
2. Sunshine Mortgage Services (proposed termination)
3. Atlantic Vanguard (termination)
4. Paradigm Mortgage (termination)
5. American Choice Mortgage Corporation (termination)
6. Cameron Mortgage Corporation (termination)
7. Citizens First Mortgage (termination)
8. Eastern Mortgage Corporation (termination)
9. Mirage Financial Services (termination)
10. Cypress Financial Mortgage (credit watch)
11. Nationwide Mortgage (credit watch)
12. North American Mortgage (credit watch)
13. American Mortgage Funding (credit watch)
14. CTX Mortgage Corporation (credit watch)
15. Interamerican Financial (credit watch)
16. Dolphin Mortgage Company (credit watch)
17. First Town Mortgage Corporation (credit watch)

**Lenders placed on 100% Post Endorsement Technical Review status**

1. Trinity Mortgage
2. Florida Trust Mortgage
3. Foundation Funding Group

**Individuals referred for Debarment**

1. Carlos Madlonad
2. Robert Barrera
3. Howard Steinholtz Pauline
4. Joseph Travers
5. Stewart Bitterman
6. Marcia Baker
7. Henry Lyons
8. Patricia Stewert
9. Stephen Rossi
10. Peter Browne
11. Gerald McCormick
12. Wamble
13. Pamela Yerby
14. James Chancelor
15. Maurice Bell
16. Robert Railey
17. Howard Treitman

**Individuals Receiving Limited Denial of Participation (LDP)**

1. James Colabelli - appraiser (Pending)
2. Anthoni Lorii - appraiser (Pending)

**Nonproftis suspended to one property at a time until ATL task force review completed**

**Non-profits**

1. Affordable American Housing, Palm Harbor, FL
2. American Spirit Foundation, Winter Park, FL
3. Breakthrough Mission, Inc., Tampa, FL
4. Central Florida Development, Oconee, FL
5. Chabad Lubavitch of Hawaii, North Miami Beach, FL
6. Haven Economic Development, Davie, FL
7. Home For Our Community, Inc., Tamp, FL
8. Housing & Neighborhood Development Services of Central Florida, Orlando, FL
9. Manfred Memorial Foundation, Miami, FL
10. Metro Orlando Affordable Housing, Winter Park, FL
11. New Concept Visions 2000, Inc., Miami, FL
12. Stewardship Foundation, Inc., Palm City, FL
13. Zedakah Foundation, Edina, MN - Doing business in Florida

**Individuals referred for further investigation (OIG)**

1. Mario Lazo - Financial Funding Services, Inc.
2. Paul M. Mazak II - MortgageOne Financial Services, Inc.
3. Donna Brown - MortgageOne Financial Services, Inc.
4. Jane Geraci - Mortgage One Financial Services, Inc.
5. Reba Mazak - Mortgage One Financial Services, Inc.
6. Todd B. Ackerman - Mortgage One Financial Services, Inc.
7. Donna Brown - MortgageOne Financial Services, Inc. (not the Donna Brown above)
8. Jacqueline Shaw - Cypress Financial Mortgage Corp.
9. Henry Yee - Cypress Financial Mortgage Corp.
10. Alfonso Morales - Cypress Financial Mortgage Corp.
11. Henry Vazquez - Cypress Financial Mortgage Corp.
12. Thomas Culpepper - Cypress Financial Mortgage Corp.
13. Monica Threat a/k/a Monica Choice - Cypress Financial Mortgage Corp.
14. Enrique (Rick) Castro - Specialty Mortgage
15. Ralph Peña - Specialty Mortgage
16. Candelario L. Rodriguez - Specialty Mortgage
17. Thomas Haws - Bankers Mortgage Trust
18. Melanie Williams - Bankers Mortgage Trust
19. Mary O'Brien - Bankers Mortgage Trust
20. Grace Solis - Bankers Mortgage Trust
21. Nathan Newman - Bankers Mortgage Trust
22. Patricia Tovar - GHI Corp.
23. Carmen Irizarry - GHI Corp.
24. Xiomara Endara - GHI Corp.
25. Milena Frometa - GHI Corp.
26. Lisa Stewart - Dolphin Mortgage Corporation
27. Patricia Alexander - Dolphin Mortgage Corporation
28. Latonya Hamilton - Dolphin Mortgage Corporation
29. Pamela Whiteman - Dolphin Mortgage Corporation
30. Idalberto Clark - Prestar Mortgage Corp.
31. Angela Clark - Prestar Mortgage Corp.
32. Mario de las Cuevas - Florida International Mortgage Co.
33. Rosy Gonzalez - Florida International Mortgage Co.
34. Emelina Ferran-Bota - Florida International Mortgage Co.
35. Emelina Ferran-Bota - Nation Trust Corp. Inc.
36. Oscar A. Alvarez - Florida International Mortgage Co.
37. Maria Ayala - Florida International Mortgage Co.
38. Richard Betancourt - Florida International Mortgage Co.
39. William E. Hecker - Chase Manhattan Mortgage Corp.
40. Daryl Weaver - Chase Manhattan Mortgage Corp.
41. Clara Gomez - Turner Mortgage Corp.
42. Michael H. O'Donnel - D and E Mortgage Corp.
43. Constance R. O'Donnel - Empire Funding
44. Sammy Silva - Crestar Mortgage Corp.
45. Alfred Giaquinto - Crestar Mortgage Corp.
46. Patricia J. Lombardi - Crestar Mortgage Corp.
47. Edward L. Lombardi - Crestar Mortgage Corp.

48. Glen Yost - Crestar Mortgage Corp.
49. Sammy Silva - Nation Trust Corp.
50. Polly Cruz - Nation Trust Corp.
51. Barbara Andres - Nation Trust Corp.
52. Donna Prosper - Nation Trust Corp.
53. David Morrison - Mortgage Funding Group, Inc.
54. Carol Weber - Mortgage Funding Group, Inc.
55. Alton Shand - Mortgage Funding Group, Inc.
56. Hanna Kateb - Safeway Mortgage & Investment, Co.
57. Ron Nottage - Paradigm Mortgage Ass., Inc.
58. Victor Carnero - Prime Investment Group, Inc.
59. Ariel Perez - Prime Investment Group, Inc.
60. Anthony Strachan - Prime Investment Group, Inc.
61. Bernes Scott - Prime Investment Group, Inc.
62. Connie Kelty - Prime Investment Group, Inc.

**Florida Lenders Referred for Further Investigation (OIG)**

1. North American Mortgage Co.
2. Paradigm Mortgage Ass., Inc.

**Other Entities referred for further investigation (OIG)**

1. WOL, Inc.
2. Shamrock Financial Group
3. M.H.E.A. Inc.
4. Property Investment Co.

Senate Permanent Subcommittee
On Investigations

EXHIBIT # 16

## FHA PREMIUM POLICY

| Year | Up-Front Premium | Annual Premium | |
|---|---|---|---|
| 1991 | 3.8 percent | .50 percent | |
| 1992 | 3.0 percent | .50 percent | |
| 1994 - present | 2.25 percent | .50 percent | for 30-year loan term |
| 1994 - present | 2.0 percent | .25 percent | for 15-year loan term |

The up-front premium on FHA-insured loans has decreased by 41 percent, from 3.8 percent of the loan amount to 2.25 percent of the loan amount, since 1991. At the same time, the annual premium has remained unchanged at .50 percent of the outstanding principle balance.

Senate Permanent Subcommittee
On Investigations

EXHIBIT # 18

# HUD: IGNORING THE WARNINGS

| | | |
|---|---|---|
| *April 30, 1993* | ***HUD OIG Audit of HUD's Direct Endorsement Program (93-HQ-121-0012)*** | OIG found:<br>(1) HUD post-endorsement reviews do not consistently ensure quality underwriting<br>(2) Sanctions were not effectively used to protect the integrity of the direct endorsement program<br>(3) The direct endorsement underwriter approval process was not effective |
| *March 31, 1995* | ***HUD OIG Semiannual Report to Congress: OIG Investigations focus on malfeasance by mortgagee personnel and brokers in the origination of loans and by speculators and investors*** | OIG found that "[a] Tampa, Florida investor created corporations to sell real estate at inflated prices and then falsified the down payments made to strawbuyers. . . . [T]he corporations he created provided false income information on the verification of employment forms, which enabled the unqualified strawbuyers to obtain both FHA and VA mortgages." |
| *February 6, 1997* | ***HUD OIG Audit Report "Section 203(k) Rehabilitation Mortgage Insurance Program (97-AT-121-0001)*** | OIG found:<br>(1) "The 203(k) Program is highly vulnerable to waste, fraud, and abuse by investors and non-profit borrowers"<br>(2) "The program design encourages risky property deals, land sale and refinance schemes, overstated property appraisals, and phony or excessive fees, and does not adequately safeguard [HUD] interests"<br>(3) "The abuses have not been isolated to any one person, group, or area of the country" |
| *March 31, 1997* | ***HUD OIG Semiannual Report to Congress: OIG investigations continue to uncover instances of wrongdoing by mortgagee personnel and real estate brokers in the origination of single family loans*** | OIG found that in Virginia Beach, VA, two real estate agents falsely represented themselves as owners of HUD properties and contracted with unsuspecting buyers. They then bid on and won the HUD owned homes for amounts considerably less than the contracts of sale with unsuspecting buyers, and conveyed the properties to those buyers on the same day they purchased them. |
| *July 21, 1997* | ***GAO Report: HUD: Information on Its Role, Programs and Issues (97-173R)*** | GAO found:<br>"HUD is considered a *high risk* agency due to long-standing, Department-wide deficiencies in internal controls, information and financial management systems, organizational structure; and mix of staff and skills." |
| *July 25, 1997* | ***GAO Report: Information on Changes in FHA's New Single Family Appraisal Process (GAO/RCED-97-176)*** | GAO report stated, "[N]o assurance exists that the FHA can monitor the quality of appraisers and identify FHA lenders with deficient appraisal practices." GAO found that:<br>(1) "A 1996 audit of HUD's Los Angeles field office by the firm of KMPG Peat Marwick under a contract with HUD found that the office had not conducted any field reviews of completed appraisals during the fiscal year 1996"<br>(2) "[A] key control over the quality of appraisals made on properties it [FHA] insures-requiring a stated percentage of field and desk reviews of some completed appraisals-was eliminated because of staffing reductions." |

| | | |
|---|---|---|
| *March 12, 1999* | ***KPMG - Internal Audit of FHA's 1998 Financial Statement (cited in HUD OIG report number 99-FO-131-0002)*** | KPMG's findings included the following:<br>(1) Material weaknesses in internal control over financial reporting related to addressing staff and administrative resource issues; placing more emphasis on early warning and loss prevention regarding the insured portfolio; and improving federal basis and budgetary accounting;<br>(2) "FHA has control weaknesses in its single family property acquisition, management, and disposition functions." The report concluded that "there was little analysis and lender follow up based on the results of [post-endorsement technical] reviews, even though certain lenders were identified with risky underwriting practices." |
| *April 1999* | ***GAO Report: SINGLE-FAMILY HOUSING: Weaknesses in HUD's Oversight of the FHA Appraisal Process (GAO/RCED-99-72)*** | The GAO report identified weaknesses in HUD's oversight of the FHA appraisal process. Specifically, GAO found that:<br>(1) "HUD is not doing a good job monitoring the performance of appraisers"<br>(2) "HUD is not holding appraisers accountable for the quality of their appraisals"<br>(3) "HUD has not aggressively enforced its policy to hold lenders equally accountable with the appraisers they select for the accuracy and thoroughness of appraisals because of disagreement within HUD over its authority to do so"<br>(4) "HUD has limited assurance that the appraisers on its roster are knowledgeable about FHA's appraisal requirements" |
| *January 14, 2000* | ***Baltimore Town Hall Meeting*** | Senator Mikulski charged that "the government [HUD] is subsidizing fraud." |
| *February 29, 2000* | ***KPMG Internal Audit of FHA's 1999 Financial Statement (cited in HUD OIG report number 00-FO-131-0002)*** | KPMG reported that post-endorsement technical reviews still needed to be improved. As in the prior audit, KPMG stated that "there was little analysis and lender follow-up based on the results of these reviews, even though certain lenders were identified with inadequate underwriting practices." |
| *March 30, 2000* | ***HUD OIG Audit of Single Family Production Home Ownership Centers (00-SF-121-0001)*** | OIG was critical of single family production home ownership centers on lender oversight. Audit disclosed significant problems in reviews of lender loan underwriting, property appraisals, monitoring of lenders, oversight of pre-endorsement contractors, and accuracy of information in the automated tracking system. These weaknesses increase HUD's risk of losses. Specifically, HUD OIG found:<br>(1) "Improvements are needed to HUD's current procedures"<br>(2) "FHA loan delinquency and foreclosure rates have risen dramatically"<br>(3) "Post-endorsement technical reviews need improvement"<br>(4) "Quality Assurance Division monitoring had limited effectiveness"<br>(5) "Oversight of pre-endorsement contractors needs improvement"<br>(6) "HUD did not place poorly performing lenders on pre-closing status"<br>(7) "HUD's tracking system for quality assurance division reviews was inaccurate" |
| *March 30, 2000* | ***Committee on Appropriations, Subcommittee on VA, HUD and Independent Agencies*** | Senator Mikulski (Ranking Member of Subcommittee) reported on what she observed in Baltimore regarding flipping, stating, "What we found was that HUD itself was a contributor to the destruction of dreams, the erosion of neighborhoods." |

| | | |
|---|---|---|
| ***April 28, 2000*** | ***GAO Report: SINGLE FAMILY HOUSING: Stronger Oversight of FHA Lenders Could Reduce HUD's Insurance Risk (GAO/T-RCED-00-213)*** | GAO calls for stronger oversight of FHA lenders to reduce HUD's insurance risk. GAO found:<br>(1) "HUD's process for granting FHA-approved lenders Direct Endorsement authority – the ability to underwrite loans and determine their eligibility for FHA mortgage insurance without HUD's prior review – provides limited assurance that lenders receiving this authority are qualified"<br>(2) "Contrary to HUD's guidance, the Home Ownership Center's monitoring of lenders does not adequately focus on the lenders and loans that pose the greatest insurance risks to HUD"<br>(3) "HUD has not taken sufficient steps to hold lenders accountable for poor performance and program violations" |